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JOINT COMMITTEE ON CORPORATIONS AND FINANCIAL SERVICES

Reference: Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003

TUESDAY, 6 APRIL 2004

SYDNEY

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JOINT COMMITTEE ON CORPORATIONS AND FINANCIAL SERVICES

Tuesday, 6 April 2004

Members: Senator Chapman *(Chair)*, Senator Wong *(Deputy Chair)*, Senators Brandis, Conroy and Murray and Mr Byrne, Mr Ciobo, Mr Griffin, Mr Hunt and Mr McArthur

Senators and members in attendance: Senators Conroy and Wong and Mr Ciobo

Terms of reference for the inquiry:

To inquire into and report on:

The exposure draft bill, CLERP (Audit Reform and Corporate Disclosure) Bill, and relevant matters.

WITNESSES

Committee met at 10.14 a.m.

LONGSTAFF, Dr Simon, Executive Director, St James Ethics Centre

ACTING CHAIR (Mr Ciobo)—Welcome. This is a public hearing of the Parliamentary Joint Committee on Corporations and Financial Services regarding its inquiry into the exposure draft of the Corporate Law Reform Program (Audit Reform and Corporate Disclosure) Bill 2003 and relevant and related matters. The committee expresses its gratitude to the contributors to this inquiry, including those who will be appearing before us as witnesses today. To date, we have received more than 60 submissions but we would welcome, and are still accepting, additional submissions.

Before we start taking evidence I wish to reinforce for the record that all witnesses appearing before the committee are protected by parliamentary privilege with respect to the evidence provided. Parliamentary privilege refers to special rights and immunities attached to the parliament or its members and others necessary for the discharge of parliamentary functions without obstruction and fear of prosecution. Any act by any person that operates to the disadvantage of a witness on account of evidence given by him or her before the parliament or any of its committees is treated as a breach of privilege. I also wish to state that, unless the committee should decide otherwise, this is a public hearing and as such all members of the public are welcome to attend. This is the committee's fifth public hearing for this inquiry. Additional hearings will be on 14 and 29 April and, possibly, in early May on dates still to be determined.

Welcome, Dr Longstaff. The committee prefers all evidence to be given in public but should you at any stage wish to give any part of your evidence in private you may ask to do so and the committee will consider your request. The committee has before it a written submission from St James Ethics Centre—submission No. 40. Are there any alterations or additions you would like to make to the submission at this stage?

Dr Longstaff—No.

ACTING CHAIR—I now invite you to make a brief opening statement and we will then proceed to questions.

Dr Longstaff—Thank you. The centre's submission focuses on the issue of whistleblower protection. There were three key elements that we sought to bring to the attention of those responsible for reviewing the proposed legislation, each in relation to whistleblower protection. The first was to do with the ability to expand the number of bodies to whom protective disclosures might be made. That has subsequently been taken on board and included in the amended draft legislation. But there are two other issues which we drew attention to and which we still think might bear further consideration. The first relates to the capacity for individuals to make anonymous disclosures and the second relates to the question of whether or not disclosure should be made in good faith.

On the first matter, we believe that anonymity ought to be an option available to people making disclosures. The only real objection to it that we can see might be a practical one of how you might identify a person who has made a disclosure subsequently if you do not have the

means to identify them. With that in mind, we think it is quite possible that those people wanting to avail themselves of this protection ought to be given a unique identifier at the time the disclosure is made—it could be in the form of a number or an alphanumeric code—so that if, at a later date, other people seek to claim protection without being able to identify themselves, the person who did make the disclosure can be correctly identified and therefore continue to enjoy the protections afforded by the proposed legislation. With that in mind, we think that, on balance, public interest is better served by having people able to make an anonymous disclosure because, although the protections are afforded under the proposed legislation, many people looking at the history of what has happened to whistleblowers might have a reasonable apprehension that, should they become known as the person making the disclosure, some detriment will be suffered by them.

The second issue—and one that perhaps might seem a more unusual submission for St James Ethics Centre to make—is whether or not disclosure should be made in good faith. This is a matter we gave considerable thought and attention to. We decided that, on balance, the test of good faith ought not to be required because the key question would be whether or not the disclosure is actually true. Again, we see that it is in the public interest that true disclosures about matters which ought to be disclosed come forward, ideally in circumstances which allow the disclosure to be made internally in the first instance so that it can be addressed by the responsible people. But, even if it is made in a public forum and protected under the mechanisms proposed, it should still simply be tested on the question of truth. That is not to say that we are indifferent to whether people might approach making a disclosure with malice, but we think that, even if they do so, if it is true then it is still something which ought to be known because people can then act on it. The question of what we do with people or what judgments we form about people who act with malice ought to be left as an ethical question. A judgment ought to be made on that basis rather than on a legal basis—that is, determined by law. So we decided that the system would be better served if the good faith test was not applied. I am happy to expand on that in answer to questions but I think those are the principal points I want to make at this time.

ACTING CHAIR—When I had a look over your submission I was quite interested. With regard to that second limb, do you think it is possible to separate the two? Do you think it is possible to determine the truthfulness of a whistleblower's claims without exploring those avenues pertaining to whether or not there is malice involved or what their intention is?

Dr Longstaff—Yes, I do think it is possible. There is one philosophical school of thought which would say that there is no such thing as truth, but it is not a school of thought to which I subscribe. I believe that there are facts about things that occur, which can be checked and validated and, therefore, determined as being true, and that their truth does not depend on what the intentions of the person who spoke the truth happened to be. In that sense, it is reasonable to make that sensible distinction between the two.

Senator CONROY—I want to discuss the good faith issue, as a number of other witnesses have raised it. You mentioned that you used to leave it to whether the motive was ethical. Do you think it matters, at the end of the day, what the motive behind the disclosure is if their knowledge is accurate?

Dr Longstaff—It does not matter, really, in terms of what the objects of the proposed legislation are, although I can understand legislators being keen to avoid any kind of reward

being given for unethical conduct, which purely malicious conduct would be. I do think the question of malice or good faith matters in general to a community and to the kind of society that we want to have, because I do not think we would be well served by having people being indifferent to the question of motives. But I think in terms of this particular legislation and the purposes which it seeks to serve it does not matter, because the principal objective should be to determine the truth so that the public interest is served by having appropriate notification made of those things which ought to be notified when there is no other reasonable alternative for somebody within an organisation.

Senator CONROY—An employee may be motivated by a malicious purpose.

Dr Longstaff—They may be, but, similarly—

Senator CONROY—There is an old saying: 'When thieves fall out'.

Dr Longstaff—Nonetheless, that will not change the fact that the event that ought to be disclosed has occurred. I would think that typically companies would want to organise their own internal mechanism so that there is some capacity to provide some positive reward for people who make disclosures for the good reasons that we might think should exist. In other words, there would not be any question as to whether the protections formally applied ought to exist or not, but there may be some additional benefit to those who are motivated by proper kinds of concerns.

Senator CONROY—As I mentioned, the committee has had some discussion on this. Senator Brandis, who is not with us today but who is a lawyer, suggested a possible alternative. Your submission refers to the requirements in the US, where there is no good faith requirement. If we remove the good faith requirement, we need to reformulate the test. Senator Brandis suggested the test should be whether the whistleblower has an 'honest and reasonable belief'. Do you think that gets us there?

Dr Longstaff—I think that could work. The test I would prefer is whether or not the claim is true, but that might be too high a test for a person wanting to come forward, because they may at that time be acting in good faith. So an 'honest and reasonable belief' would be acceptable. It is to do with the fact that the person holds the belief. The reasonable test would be where I put the most weight, because the belief needs to be well founded and not some idle bit of speculation by the person seeking to have protections.

Senator CONROY—I want to talk about anonymous disclosures, which you referred to. Your submission says that whistleblowers should be able to be anonymous as they often fear the threat of reprisal. From a practical perspective, how do you offer the protection afforded by this bill to someone who remains anonymous?

Dr Longstaff—You allow a person to be identified if they seek to take advantage of the protection. The protection, as it would work, would be afforded to them from the moment they made the disclosure in an appropriate form. It is then a fact that it exists as a legal protection. It is up to them, though, to invoke it, and they can do so at any time. That might risk their anonymity, but if they wish to sit by and see what happens—and let us suppose they live in a more ideal world than most do live in and that there is no retribution for the disclosure having

been made—then they may never invoke the formal privilege. But if they do so we need to be protected from the fact that a number of people might falsely claim that they have made the disclosure unless there is some unique identifier. The mechanism that we would propose as a practical measure is in that form.

Senator WONG—On the good faith issue, given that this is legislation which seeks to give people protection, would you agree that there should be some filtering mechanism so that not everybody who discloses something should be given the benefit of legal protection in this way?

Dr Longstaff—No, particularly no-one making a false claim ought to be protected.

Senator WONG—On that—and this is why I am attracted to Senator Brandis's formulation—if you utilise the truth or otherwise of the allegation as the qualifying factor, in fact you may be worsening the situation for some people who might have believed something to be true and, therefore, have complied with the good faith test in order to gain protection. But somebody who makes an honest and reasonable mistake as to the veracity of what they are disclosing, which they subsequently find to be untrue, may be deprived of protection under the legislation—that is a perverse outcome.

Dr Longstaff—It would be a perverse outcome. I am attracted to Senator Brandis's proposal.

Senator WONG—It is not an unknown formulation.

Dr Longstaff—No, it is not an unknown formulation. I suppose one of the things that does flow from the kind of proposal we put in its rather raw form is that people would probably approach making a disclosure with a proper degree of caution because they would know that they needed to be reasonably certain of the truth of what they were saying—in fact, they should be certain that it is true—before they would seek to make the disclosure. I accept that that may be too high a test to apply, so that is why I think perhaps a better formulation is that which Senator Brandis has suggested.

Senator WONG—Otherwise you actually might be making an error and then be deprived of protection.

Dr Longstaff—It might be a genuine error and they have made as good an inquiry as they could have made and, subsequently, they find they are without protection—I accept that, yes.

ACTING CHAIR—On your issue dealing with anonymity, I recognise that you say there should be a mechanism to follow it back. However, where you have a vexatious or a frivolous report, how would you see it actually operating in terms of having active discouragement? I am interested as to whether or not, because you have that ability to track it back, you are in fact circumventing any of the incentives that would apply through having the ability to report or disclose under anonymity.

Dr Longstaff—It is not really an ability to track back. You provide that person with a unique identifier so that, if they invoke the privileges of the protection, you can be sure that that is the correct person who is doing so. All you would know in practice is that you received some kind of a call. If they choose to be anonymous, you give them the unique identifier. From that point

on, you may not be able to track them back, but the onus would then be on them if they wanted to invoke the privilege of the protection and say, 'I am the person who was protected from that point of call. I can prove that I was by the provision of this unique identifier.'

That does not really go to the core of your question, which I think was about whether or not there are some other practical difficulties with not knowing the identity of the person who makes a protected disclosure. From what I have seen in practice with schemes which do operate like this—for example, hotlines and other services provided within companies already where a person can make an anonymous disclosure, albeit without the protections—typically what happens is that the information is sufficiently detailed to allow, say, a company to begin its own investigations to determine whether or not the thing that is said to have happened has in fact happened. So they are not really encumbered by any inability to pursue the matter because, typically, it is set up to find out exactly what you do need to know. If a person will not give you the information sufficient to proceed from that point then their bona fides in that matter in one sense would be open to some question because they will not provide the means by which the actual process can go forward. The actual day-to-day doing of this work determines the basis on whether or not you can proceed more than the identity of the individual who is actually making the disclosure.

ACTING CHAIR—You speak about other bodies and in your submission you touch on whether or not it should be broader than just ASIC. Would you like to expand on that for the committee?

Dr Longstaff—I think that argument may already have been accepted. What we were concerned to do was to ensure that there was some encouragement given, particularly to corporations, to establish internal mechanisms to which people could make protected disclosures. Our preference is that, if possible, organisations should be informed of issues arising in their own structures and be given at least an initial capacity to investigate and resolve those issues. I think that would better serve the proper purpose of management and the governance structures within companies. That was not going to be allowed if it was simply a disclosure to ASIC. As I said before, there are a number of programs already running within companies and in other organisations where disclosures can be made. They allow anonymity and they work well, but of course they do not have the formal protections considered by the bill.

ACTING CHAIR—So in terms of internal disclosure regimes, say, would you seek a mandated enforcement of those sorts of operations?

Dr Longstaff—That every company ought to? No. I think it would be a prudent form of best practice for companies to put in either their own internal one or something which is close to internal which they have some responsibility for arranging. Providing that the legislation does provide an alternative to go to an external party, such as ASIC, then the public is being served. Why a board or management would not avail themselves of the opportunity to create an internal mechanism under those terms I do not know, because it would certainly be in their best interests to do so.

ACTING CHAIR—What about the breadth of people eligible to be protected? Are you comfortable with the reach at present or do you think it needs to include, for example, suppliers of goods?

Dr Longstaff—I can see new arguments, increasing arguments, why it should extend beyond simply employees. I know that this would cause some concern in certain circles, but business practice is developing now, with the integration of suppliers and the whole importance of the supply chain. I do not know if we are quite there yet, but, given the prevalence of that practice, I can see we are heading in a direction where you might very well contemplate including those people who are, if you like, integral players within a business's activities. Is that something which is being canvassed?

ACTING CHAIR—It is an issue that the committee has discussed and has been raised, so we are keen to get different points of view on it and hear people's thoughts on the issue.

Dr Longstaff—I am not a lawyer, so I do not know what the implications are around contracts and other things, but if you ask: 'Is it a general issue? Is there likely to be a case for extending it to critical players within the life of a company's activities?' then I would say, 'Yes, that makes some sense and will increasingly do so in the future.'

ACTING CHAIR—In terms of actually encouraging the reporting of wrongdoing, and preventing unlawful reprisals that flow from that, do you think that the current model sends the message that the whistleblowing scheme is in fact focused on these areas and is not open to frivolous and vexatious claims?

Dr Longstaff—I do. I think it is not just because of the specific legislation itself but because of the general context in which it has been proposed. I think that the default setting for people is to take these schemes quite seriously and to understand that they ought not to be used for vexatious reports or for frivolous claims to be made. I think that within that context, which is unlikely to change, the balance is pretty right.

ACTING CHAIR—There is another point with regard to multiple directorships. In terms of keeping good corporate governance, do you think there is an argument for legislating to place some limit on the directorships a person can hold?

Dr Longstaff—On balance, no, because I do not know how the legislation would actually allow a proper determination of the particular details of any one director. Different directors have engagements which bring different weight upon them in terms of the contribution they need to make. It is not just a variable around things like the size of the company—quite large companies can have relatively low workloads because they are well organised and are operating well, while small companies can have massive requirements of directors. So taking a fixed number of companies as an index of overcommitment I do not think would make much sense. Rather I would like to see some mechanism, probably an informal mechanism, by which those directors who overcommit are able to be identified by their peers and there is some safe process by which pressure will be brought to bear in order to have them scale back their commitments so that they can properly discharge their duties which arise under the law.

ACTING CHAIR—So would that be, again, just a case of best practice?

Dr Longstaff—It would be. The reality is that there is some kind of moral courage required, I suppose, by other directors, to tap people on the shoulder when they think that they are underperforming and say, 'Are you really certain that you are able to discharge these duties?' To

say that it is just a matter for a single director to determine on their own judgment, I think is probably not right, because they are probably prone to overestimate their capacity to do the work. Unfortunately, at this point in time I do not think we have a community of directors—if I can call it that—who are capable of dealing particularly well with failure within their own ranks. But I do not think a formal legislative provision saying, 'This is the cut-off point,' would actually do the job. It is more about the culture that exists within boardrooms.

ACTING CHAIR—You would be familiar, obviously, with the cooling-off periods that are envisaged as part of the legislation. Would you be keen to make some comments on your thoughts on that? For example, other submissions have indicated that, for a former auditor who seeks to move into corporate management et cetera, the cooling-off period should apply from the time the auditor no longer has that company as a client, rather than from the time that the auditor leaves the firm they were with. Would you be interested in making some comments on that or, more generally, about the rotation and cooling-off periods?

Dr Longstaff—I do think that there is some benefit to be had from specifying cooling-off periods. I think that the benefits come from the peculiar time in which we find ourselves now, where there are such low levels of trust in all sorts of institutions, but in this case around the institutions of business, and a perception within the community that those who provide professional services in some senses have become less like members of a profession and more like people who participate in various businesses that just happen to offer what used to be called professional services. The distinction between a business and a profession is important in this, although this is probably not the place to go into it. The more significant point is that the public, I think, has lost a degree of confidence.

In normal circumstances, you would say, 'Oh well, this is just a matter that the professions can be left to deal with themselves,' but I do not think we are in normal circumstances. I think we are in extraordinary circumstances at the moment, where people have to go beyond what would be normal practice in order to restore trust. On that basis, at least for a period of time, a requirement for a cooling-off period makes good sense. As to whether it should begin from the point at which a person or a firm is no longer involved with a particular client, that again goes back to a view about whether or not the traditional views about a partnership—where the knowledge of one partner is deemed to be the knowledge of all—prevail as an ideal, albeit a fiction, in large organisations, or whether or not that can be set aside for some of these more corporate models that now exist. In that case, the existence of Chinese walls and the sheer size of these organisations mean that, once you no longer have involvement with a company, you are truly removed from any contact with its affairs.

If you wanted to have an abundance of caution in relation to this, you would start the cooling-off period from the point when the firm discontinues its association, the argument being that, before that point, there is some reasonable basis on which a partner—particularly in a partnership—might be notionally in possession of information about the firm and have some kind of vested interest in and/or connection with them. That means that the cooling-off period would not have been effective if it had just started from the end of that particular individual's association with the client.

ACTING CHAIR—Have you looked at the separate issue of the threshold tests that apply to objective and transparent reasonableness when it comes to a conflict of interest, and the tests that

apply for that? Do you have any comments about the different measures that may be introduced with respect to conflicts of interest?

Dr Longstaff—No, not specifically within the legislation, but I am happy to answer questions on matters of general principle, if you want to outline those.

ACTING CHAIR—Something the committee is looking at, for example with respect to conflicts of interest, is the issue of the reasonable person making a decision or, indeed, the actual party doing the audit being not capable of forming an objective and impartial view about any conflict of interest. As a threshold test, I would be interested in your comments on whether you think that goes too far, is an appropriate balance or does not go far enough.

Dr Longstaff—Let me give you some general thinking on it—it may or may not be helpful in relation to that. My general view about conflicts of interest—perhaps more in the sense of a side comment—is that they are better off termed 'conflicts of duties' that can arise in these circumstances. Either way, to get a proper sense of what is at stake here, there is a standard framework that makes pretty good sense to me, which is based around disclosure and informed consent. I do not believe that a person who has a conflict of duties, such as an auditor or any other person providing professional services, can of themselves determine that it is appropriate for them to continue to act in a particular matter. I think it can only be decided by those people whose interests are actually at stake—where there is a conflict of some kind. On that basis, if they give informed consent, that should be enough to continue. At least it should form a rebuttable presumption in favour of people being able to continue on that basis. But it is very important in that case that those people who are in a professional relationship be diligent to their ability to identify and disclose the conflict and that they be prepared to be bound by those people whose interests are at stake.

ACTING CHAIR—Does your organisation have any thoughts on the prohibition or otherwise of cross-selling of non-audit services?

Dr Longstaff—No strong views. I can understand the arguments that have been put in terms of the way the provision of services, such as audit services, could potentially be affected by considerations other than the direct professional obligations that arise around, say, auditing, mainly by the provision of other services. If I sound ambivalent about this, I am a bit, because I do believe it is unfortunate in some senses that we have got to a point where we do not believe that the professional obligations are sufficiently well held to be able to act as a bulwark against the temptations that might apply in other areas.

I have no doubt that there was a time when people did provide a range of services under one global structure, and they did so totally faithfully in terms of their duties owed to the clients and to the community as auditors. They understood that, as professionals, there was a social compact which they needed to honour, and that was enough. I am not sure at the moment that the professions have given enough attention to the maintenance of the culture that makes that possible. So my ambivalence comes from the fact that, I think, in an ideal world—and a world that used to exist—it would be possible to have a kind of omnibus service provider. But until such time as the professions are able to be clear that that is what they want to be—namely, a profession rather than a series of businesses providing professional services—I think that some formal distinction of what they do may be required.

ACTING CHAIR—Do you see that erosion of professional standards coming about through a breakdown in the educative process or on the enforcement side?

Dr Longstaff—I think it is a mixture of things. What we ask professions to do is a fairly extraordinary thing. We live in a world in which the general settings for what we do are determined by the philosophical underpinnings of a market economy in which the pursuit of self-interest is formally acknowledged and licensed, in a sense. We believe that individuals pursuing their self-interest will lead to an increase in the common good because of the operation of the so-called invisible hand. What we say to members of the profession is something quite extraordinary: we don't want you to do that. We actually want you formally to exclude the pursuit of self-interest in favour of acting in a spirit of public service. Each profession has a defining end and each of them has a responsibility, as I say, to act in a spirit of public service where their own personal interests come right at the bottom of those things they might give consideration to—the welfare of a client or of the community are ahead of their personal interest.

In times gone by we recognised more formally the extraordinary nature of what we ask members of the professions to do and entered into a kind of social compact in which a number of benefits were recorded in return for that promise being kept. There were limitations on the kinds of work that might be done, there was a certain kind of status attached. One of the things that has happened over time is that we have seen a progressive erosion of the bargain and so a lot of people in professional life—you see it within the law, you see it within accounting and other things—have said, 'Well, if that's what it means to be a profession and if the benefits of that social compact have eroded as part of broader social change, why should we stick to it?' It has become very tempting under those terms actually to become a business or a guild or something like that which is not defined by those professional obligations.

When that happens, it affects a whole lot of things. The context within which the education of members of the professions takes place changes and the credibility of a claim about ethical commitments becomes open to question. There is general erosion that takes place. I do not believe it is irreversible but I do think it is quite a serious matter of public policy as to what we do about the professions in this country and how we restore some of the balance. I hope, I think not in a naive way, that it will be possible to get that balance right, because I think society is far better served by having an informal set of self-regulating gatekeepers who actually are able to exercise judgment about the public interest without having to rely exclusively on legislation, regulation and surveillance in order to protect us. I think we are far better served economically, socially and in a whole lot of ways by having strong professions, and I think we have lost too much without even noticing it.

ACTING CHAIR—Does the CLERP 9 introduction of incorporation of auditors and proportionate liability run counter to the idea of professionalism?

Dr Longstaff—The incorporation elements can do. I think there are some risks in that. I have always been concerned about incorporation. I understand some of the business cases that are made by people who have an interest in this but I think that does run counter to it. The notion of proportional liability and even some of the discussions in other places about the capping of liability under professional standards legislation I think do make sense, for the kinds of arguments I was just referring to a moment ago in terms of the social compact. For example, where liability issues are either allocated differently or capped, society is saying to members of

the professions, 'Providing a prudent level of provision is made for people who may be placed at risk by you through the profession of your services or the schemes ensure basic coverage, there should be some ability for society also to recognise that, in return for you undertaking your professional obligations and proper and prudent systems of risk management, we will confer a benefit which ultimately benefits society as a whole.' So I think the liability issues are not so much a concern for maintaining that sense of professional status. Incorporation is a real risk because it pushes us further along the line to saying these are just businesses. Maybe that is what they are now and maybe we need to acknowledge that and let go of the myth, but I believe we lose something as a society if that happens.

ACTING CHAIR—On that point, submissions from other witnesses have tended to indicate that there is a reluctance to engage in the activity without those protections being afforded. Do you think it is swings and roundabouts?

Dr Longstaff—I actually think that reluctance may be overstated. If the protections in terms of proportional liability and limited liability, the cap, are there so that people know they are not going to be completely ruined by an honest mistake while still making sure that the public interest is served by risk management and a prudent level of insurance in the form of protection, then I think there are lots of people who are still going to be attracted to the ideals that underpin what professional service used to be. It is not a peculiar phenomenon just for people in the professions. We see all around us now an increasing number of people who are looking to find work that is meaningful. In terms of seeking private employment in businesses, businesses all around the place, not just in Australia but also around the world, will talk of people who are actively choosing employers for whom they can feel proud to work.

The ideal of being a member of a profession I think is still very attractive to people but, as I say, it has lost some of its credibility. From talking to the accounting professions, I find it extraordinary that one of the things that their younger members press them to do more about is ethics. It is not about, 'Make us more skilful so we can earn a lot more money', it is, 'Do more to try and establish a profession to which we can belong and feel proud.' I think that, if you solve the liability issues, that is the major thing being done. The incorporation I think is about something else.

ACTING CHAIR—Thank you for appearing today, Dr Longstaff.

Proceedings suspended from 10.52 a.m. to 11.04 a.m.

BURKE, Ms Julie Catherine, National Policy Manager, Securities Institute of Australia

MARSHALL, Mr Scott Edward, Member, Company Reporting Subcommittee, Securities Institute of Australia

NEAL, Mr Ian Richard, President, Securities Institute of Australia

ACTING CHAIR—Welcome. The committee prefers all evidence to be given in public, but should you at any stage wish to give any part of your evidence in private you may ask to do so and the committee will consider your request. The committee has before it a written submission from the Securities Institute of Australia—submission No. 11. Are there any alterations or additions you would like to make to the submission at this stage?

Ms Burke—No.

ACTING CHAIR—I now invite you to make a brief opening statement and we will then proceed to questions.

Mr Neal—Thank you for the opportunity to provide comments on our submission to Treasury on the CLERP 9 bill. The Securities Institute have a vital interest in this legislation as our mission is to raise professional standards in the financial service industry. Our members, which now number over 11,000, are involved in a diverse range of areas, including stockbroking, funds management, investment banking, accounting law and, increasingly, financial planning. In line with our mission to raise industry standards our members want improved transparency and disclosure in corporate reporting as this results in investor confidence in our capital markets and, ultimately, a lower cost of capital. Overall, we believe that the bill represents a reasonable, balanced and considered alternative initiative by the government as it is aimed at achieving increasing transparency and disclosure of financial reporting, improved corporate governance and greater investor confidence.

Fortunately, Australia has had time to learn the lessons from hurried moves by some overseas regulators to restore confidence in the system. We believe the challenge is to strike an appropriate balance between regulation and commercial activity. We do not want an overly prescriptive regulation that stifles competition and commercial activity aimed at servicing investors' needs. In our view, education and instilling an ethical culture within companies is always better than a heavy-handed regulatory approach. The institute have endeavoured to educate and train and instil ethical standards in the industry for nearly four decades. In our view, integrity is a personal attribute that is innate but that can be acquired. The institute endeavour to achieve this through various education and training programs and member initiatives that focus on promoting ethics and professional conduct.

Returning to the bill, I will make a few brief remarks and then we will be happy to answer any questions. The institute are generally supportive of the bill. However, we hold some concerns about the practical implementation of some of the measures proposed—although not about the objectives underpinning the reforms. For example, in our submission we sought clarification on various issues concerning the FRP concept. How will the panel's non-binding decisions on a

single dispute issue related to a company's financial reporting fit into the hierarchy of interpretive decisions or guidance related to accounting standards? Will there be a conflict between FRP's non-binding ruling on a company and the UIG or IFAC? The FRP procedures for decision making are not particularly detailed or apparent in the commentary to the bill and require further clarification.

If the FRP functions like the takeovers panel, we believe it will provide an effective and viable dispute resolution mechanism to the courts. We have suggested that, where ASIC disputes a matter in a company's financial report, the company as well as ASIC should be able to refer the matter of dispute to the FRP for resolution. Further, the FRP referral option could be made available to the auditor. The institute supports the CEO and CFO signing off on and certifying to the integrity of a company's financial statements. We are also supportive of the requirement to prepare an MD&A. This is extremely valuable to analysts and is consistent with increasing transparency and disclosure by reporting entities. We suggest that the G100 guide to MD&A be incorporated as a schedule to the legislation or a practice note to be issued by ASIC or the FRC. Close and ongoing monitoring of the MD&A will be required if it is to be successful.

In our submission we endorse the legislative extension of the financial services licensee's general duty to manage conflicts of interest by means of disclosing, avoiding or controlling conflicts of interest. The committee would be aware that the institute has been actively committed to raising industry standards in this area with the 2001 issue of the *Best Practice Guidelines for Research Integrity*—principles which we have promoted and encouraged our members and industry to adopt. Following our recent response to the ASIC policy proposal paper on managing conflicts, we are currently consulting with ASIC on the implementation details of the proposed new conflict of interest provision to ensure its appropriate application to large and small brokers alike and to the practical realities of operating a business.

I will not dwell on the issues of continuous disclosure and infringement notices as I am certain that the committee has heard sufficient evidence on this matter. Along with a number of other industry groups, the institute opposes the proposal to grant ASIC the power to issue infringement notices for breaches of continuous disclosure provisions. If the government is determined to proceed with the proposal, we offer a number of practical recommendations in our submission to improve the practical application of this proposed reform.

Finally, the committee would be well aware of the institute's important role in advocating reforms of market policy issues. This is an area where we have considerable expertise and strong membership of investment bankers. Fundraising laws are of vital interest to this segment of the membership and we fully support reforms aimed at ensuring offer documents contain accurate information presented in a non-ambiguous manner. This will enhance transparency and assist investors in making an informed investment decision.

In our submission we made a number of points about fundraising documents, including our strong opposition to the proposal to allow ASIC to issue a stop order on prospectuses on the basis of subjective criteria relating to only presentational matters. This has very significant commercial implications and is a very powerful tool at ASIC's disposal. We are very concerned that the subjective nature of this requirement will make it difficult for ASIC to implement and apply it consistently. Our submission also contains some comments about product disclosure statements for continuously quoted securities. We welcome these reforms in concept but raise

concerns about the non-prescriptive nature of amendments, which would inevitably result in a lack of certainty when challenged.

The institute supports most of the proposals put forward in the bill, but our concerns arise in the detail of the package. We need to ensure that the right balance is achieved between protecting investors and promoting consistency and innovation. We also want to foster efficient and effective markets and ethical practices in the industry. We would be happy to elaborate on the matters I have raised or answer any questions the committee may have.

ACTING CHAIR—Thank you, Mr Neal. In particular I welcome some of the comments that you made about the principles, but you harbour some concerns about the practical application. In your submission you advocated a financial reporting panel that is based on the takeovers panel, in terms of the model and the support. Membership would not be restricted to only accounting professionals. Would you care to expand on that in terms of which key features of the takeovers panel you would like to see adopted in the model applying to the financial reporting panel?

Ms Burke—What we found with the financial reporting panel—which is something we had suggested in our response to the CLERP 9 issues paper in November 2002—is that we would look for an arbitration panel, similar to the takeovers panel, to resolve issues or disputes in relation to the application of financial reporting and accounting standards. There is a similar body in the UK, under the Financial Services Authority. Out of interest, they also have some practitioner panels and consumer panels, but I am not necessarily advocating panel mania and taking things outside of the court's jurisdiction or putting them under the Corporations Law. What we wanted with the financial reporting panel was an effective and responsive mechanism for resolving disputes in relation to the interpretation and application of financial reporting issues, and we saw this panel model as a cost-efficient and quick response solution. What we would like in the membership of the panel is representation of preparers, users and corporate issuers, so that it has a mixture of expertise and is not highly skewed to any legalistic or technical accounting interpretation.

ACTING CHAIR—You made reference in your opening statement about company referrals in addition to them being limited only to ASIC. Would you like to expand on your rationale for that?

Ms Burke—What we saw in the FRP as proposed was that it seemed to be after the event. We submitted—and it was also proposed by the Institute of Chartered Accountants—that there be pre-issue of the financial reporting materials; that is, some mechanism to address contentious accounting interpretation issues before publication. So, instead of it being after the event, the FRP would be an interpretation type body that would then fend off mistakes being made or address issues of concern in relation to applying financial reporting accounting standards in practice.

ACTING CHAIR—In terms of the concerns that you raised about the non-binding ruling, if the financial reporting panel were to get involved in prepublication disputes it could create problems with regard to the status and reliability of pre-approvals in view of the fact that the financial reporting panel may not be in a position to take into account all the relevant facts in advance. Would you agree with that? Would you have a response to that?

Ms Burke—Yes. We found that in the proposal on the FRP we could not quite understand how it stood in the hierarchy of interpretive bodies. With the transition to international accounting standards, if there is the FRP body, under the Australian Accounting Standards Board we already have the urgent issues group. As we alluded to, sometimes there was no practical detail. We could not understand what the workings of the FRP would be. Therefore, in proposing it, we sought clarification on what you want to achieve from the FRP. One of our suggestions is that it would be, as you said, a pre-vetting just so that there would be some interpretive guidance.

ACTING CHAIR—Would you foresee that possibility for the panel if there are problems as a consequence of not knowing in advance?

Ms Burke—Yes, but I think a lot of things in relation to establishing the FRP have to be duly considered. It would really depend on the membership and actually the sort of accounting issue that was put to the panel. But I think it would be some assurance for reporting entities that they were applying the financial reporting standards correctly and that, if they had the seal of approval of the panel, they would use their best endeavours to apply that—it would be similar to a due diligence. But we do have concerns about the interpretation being on a case-by-case basis and, specifically, on the facts of the particular reporting entity or ASIC coming to the panel for interpretation. We did not know what precedent value any of the decisions of the FRP might have, so that is another detail that has to be fleshed out.

Senator CONROY—Bearing in mind the accounting standards and auditing standards would have the force of law under the proposal—

Ms Burke—Yes.

Senator CONROY—The comparable role is the tax office and its private, albeit, binding rulings which have turned into a debacle.

Ms Burke—They are specific to the actual entity, but one wonders what the broader application is.

Senator CONROY—They are now published for everyone to look at. Because of the inconsistencies in interpretation there is a great danger—

Ms Burke—Whether they are authoritative.

Senator CONROY—Yes, that they become authoritative. In his submission to the committee, Keith Alfredson—and I am sure he is known to you; he is the former chairman of the AASB—

Ms Burke—Yes.

Senator CONROY—states:

Such a process would ... undermine the independence and professionalism of auditors and could become a process for allowing auditors not to have to make the tough decisions ...

Why shouldn't auditors have to take a stand on the interpretation of the accounting standard? Is that not their job?

Ms Burke—Yes, I think they would agree with that. They are quite rigorous in how they apply their auditing value judgments in their profession.

Senator CONROY—Keith's point is that he believes it would undermine their independence if you are going through this prevetting process. Do you not agree?

Ms Burke—No, I do not necessarily think it would undermine their independence. In fact, I think most auditors are quite confident in the judgments that they make. If there is some uncertainty with the reporting entity and there is an issue to question the auditor on, they can go to an independent panel to seek resolution if it is some problem that is not being resolved between the parties.

Senator WONG—But is that not just handballing it to the FRP?

Ms Burke—Yes, in a sense it is.

Senator CONROY—So what are you paying for?

Ms Burke—What are you paying for—exactly.

Senator WONG—We want to envisage a process where, as Senator Conroy says, auditors decide: 'This is too hard, my client does not agree with me, let's go and get an FRP ruling to sort it out.'

Ms Burke—The whole establishment of the FRP is that it should not be overly used for that type of litigious purpose; it has to be a genuine issue that is problematic and not being resolved.

Mr Neal—The analogy you are running is a takeovers panel; that is working pretty well, is it not?

Ms Burke—Yes; but that is more an arbitration panel after the event. This is pre event.

Senator CONROY—It is a quasi High Court that makes its own decisions, amends the Constitution—don't worry about it!

Ms Burke—The concern we were making out in our issue with the FRP referral power was that it was only ASIC that was able to refer a matter to the FRP. So we were looking at why the reporting entity could not also avail themselves of that.

Senator CONROY—Do you think that, if the FRP process were followed, anybody would be left to turn up in court to be an expert witness?

Ms Burke—Do you think they would all be on the panel?

Senator CONROY—I do not think there would be anybody left. Unfortunately, we have a relatively small industry, and I suspect that almost everyone would end up being involved in the process in one way or another, such that if you had to go to court you would not be able to find an independent expert to testify.

Ms Burke—Yes.

Senator CONROY—I think that is a logistical problem, more than anything else.

Ms Burke—And it all depends how wide you cast the net for the membership of the FRP.

Senator CONROY—It could become a hot ticket item, like the takeovers panel—the most sought after committee in town.

Ms Burke—With financial reporting being so general, and given the various standpoints of the preparers and the users, what we would like on the FRP is someone from the report user perspective.

Senator CONROY—I am presuming it would be an expert subcommittee. Given the membership of the FRP, I could not imagine that it could actually make a competent decision on the technicalities of an accounting standard. It would depend who was on it, as I think you said earlier.

Mr Marshall—Could that be addressed by the strategy of the takeovers panel, which has at its disposal many members with many qualities?

Senator CONROY—That is what I am worried about. There will be no-one left to testify in court!

Mr Marshall—A logistics problem.

Ms Burke—Such as a research analyst. Scott is an example of someone from the analyst community whom we think would be appropriate for a financial reporting panel, because the analysts are the interpreters, the intermediaries, of the financial reports.

Senator CONROY—Soliciting in a public committee is not a good idea, even if it is on Mr Marshall's behalf.

Ms Burke—They could provide the details as to whether it is appropriate to the industry and is comprehensible and interpretable to the end user. They often discover some anomalies or inconsistencies in reports, so they have eagle eyes.

Senator CONROY—Sure. Get that CV polished up, Scott.

ACTING CHAIR—In terms of oversight for the financial reporting panel, I am interested in your thoughts about what safeguards should be in place to ensure independence from the reporting council et cetera.

Ms Burke—From the FRC?

ACTING CHAIR—Yes.

Ms Burke—I understand that with the CLERP 9 reforms the oversight responsibilities of the FRC are being expanded to take in auditing. You would have to see what is happening with the international accounting standards. We did raise some issues in relation to independence from the FRC and as to what would be the most relevant oversight body for the panel. That is one of those issues that has to be fleshed out, depending on the objectives you want to achieve from establishing the financial reporting panel and how wide you cast the net. In relation to the financial reporting panel, there have been other models—such as a panel for continuous disclosure and a markets policy type panel—so it depends how wide you cast the parameters of the financial roles and responsibilities of the financial reporting panel as to which body it should sit under. In relation to the Financial Reporting Council, I am concerned that its responsibilities are building up in relation to oversight. We have concerns about the funding and the resourcing of the FRC. That would then impact on how you would establish the financial reporting panel also.

ACTING CHAIR—Does the Securities Institute have a position with respect to the division of responsibilities between panels, or is it just an issue you would like raised?

Ms Burke—We were just raising those issues. We were raising the mechanics of the proposal for the FRP. Yes, we support this proposal for the FRP, but we just wanted to know how it was going to work in practice, so we raised the issues about membership of the panel, the hierarchy of its decisions—if they are non-binding, where do they sit as an interpretive body?—and who would be given the responsibility of the oversight of the financial reporting panel. This would depend on whether you stick closely to the takeovers panel model or take into account other models used in other jurisdictions.

ACTING CHAIR—But your preference is the takeovers model. Is that correct?

Ms Burke—Yes, it is, because we see that as a successful model in application.

ACTING CHAIR—With respect to panel membership, you raised concerns in your submission that the FRP does not guard against the idiosyncrasies of panel members having adverse impacts. Would you like to expand on that?

Ms Burke—I am sorry; could you repeat that please?

ACTING CHAIR—In your submission, you raised the issue of the membership of the panel not having due regard to the idiosyncrasies of panel members. I am just keen for some expansion on your concerns there.

Ms Burke—That comment also goes back to membership of the particular panel on a case-by-case basis and the need for the procedural guidelines for the duties and obligations of the panel to be clear and consistent so that the application is too. I realise that that is a very big ask. Obviously the issues are very wide ranging and particular to the concern that ASIC might have in referring a matter to the FRP or the reporting entity—in relation to the financial reporting or

accounting treatment problem over which they might be raising concern, either before or after the issue of their reports.

Senator WONG—With respect to the improved disclosure in relation to fund-raising documents, I think you have a concern in your submission with the 'clear, concise and effective' formulation?

Ms Burke—Yes.

Senator WONG—Can you explain—

Ms Burke—the subjectivity of that?

Senator WONG—Yes. That is already the formulation in relation to PDS.

Ms Burke—Yes. And we realise that it has been acknowledged in the bill.

Senator WONG—So you do not have a concern with it in the context of product disclosure statements, but you do in relation to fundraising documents?

Ms Burke—It is already with PDS. In relation to fundraising documents-prospectuses, we do understand that it is subjective in its application, but we stress that it should be used as a presentation requirement. We understand that. Having seen the PPP that came out yesterday on product disclosure, we can see that there are good principles of disclosure in PS 168. In applying 'clear, concise and effective', in wording and presentation, it is subjective, but we do endorse the fact that it will lead to better information and greater transparency.

Senator WONG—Informed investors, hopefully.

Ms Burke—Exactly.

Senator WONG—I understand this to be your position: you accept the test—

Ms Burke—Yes.

Senator WONG—but you want ASIC to provide something akin to what has been provided in relation to PDSs—that is, some guidance as to what that would actually mean in practice.

Ms Burke—Yes, and we can see that has been addressed by the PPP released yesterday. But in relation to the stop orders—be they interim or final stop orders or akin to those—as we said, it is a presentational thing, but it can have great commercial implications.

Senator WONG—Sorry, what are you talking about?

Ms Burke—The potential stop order that ASIC can impose on a noncompliant prospectus for not being 'clear, concise and effective'.

Senator WONG—But as I understand your position you do not oppose that formulation; you just want ASIC to be clear with your members as to what they would have to do in their prospectuses—or is it prospecti?—in order to comply.

Ms Burke—Yes, and with the stop order provisions at the moment I think there is not sufficient feedback to the industry.

Senator WONG—You could probably work it out reasonably quickly, though—

Ms Burke—You do not really know what the concerns are. So in relation to the guidance, there could be examples or whatever of what is not clear, concise and effective so that you can see the practical application and it is not just particular to the actual issuer of that prospectus. There could be some wider examples of 'clear, concise and effective' given by way of guidance. But each security issue is peculiar to itself.

Senator WONG—Assuming that ASIC do issue some guidance, is it your position that you would oppose ASIC being left with the power to issue stop orders in relation to prospectuses? I am not clear what you are saying.

Ms Burke—We support the issue of the stop order and also especially the opportunity to correct any defective ones.

Mr Neal—The issue is simply clarity as to what ASIC is going to stop or not stop.

Senator CONROY—Yesterday ASIC released a guidance paper relating to product disclosure, which gives guidance on how ASIC will administer the new 'clear, concise and effective' disclosure rule. I appreciate it was only yesterday. Have you had a chance to have a look at it and have you any thoughts on it you would like to share with the committee?

Ms Burke—Yes, I have. I see they are asking some good questions there. I was happy that in talking about 'clear, concise and effective' in wording and presentation they set out some good disclosure principles from PS 168, talking about structure and length and things like that. What we are asking for is some guidelines in fleshing out the application of 'clear, concise and effective', be it for prospectuses or PDSs.

Mr Neal—From what you can see at the moment, it is heading in the right direction.

Ms Burke—Yes. It is all to do with transparency and, as Senator Wong said, leading to better informed investors.

Senator CONROY—Your submission supports the amendments relating to the exemptions from disclosure obligations for secondary sales. Can you outline to us how these would assist the industry?

Ms Burke—This has already been addressed by some class orders, so we saw providing these exemptions for on-sales, secondary sales, as the amendments coming to the Corporations Act that had already been put in place with the class orders.

Senator WONG—Do those class orders exempt? What is the scope of the class order in the policy statement you refer to?

Ms Burke—It is all to do with the anti-avoidance rule. It was exempting the disclosure if the material is already out there. When you are selling on in a secondary sale, it can be referred to the materials that are already out there, so there is not the implication for the PDS.

Mr Marshall—If there is equivalent information in the marketplace, you would expect to find a prospectus already and then you get the exemption.

Ms Burke—Exactly.

Senator WONG—Could it be used as an avoidance mechanism?

Mr Neal—It depends if there is information in the—

Mr Marshall—I doubt that it could be used for avoidance because the information has to be out there.

Senator WONG—It already has to be out there?

Mr Marshall—It has to be equivalent to prospectus material and, I believe, issued in the last 12 months. So you could only avoid if you had not already issued the information to the marketplace—hence, you come into other problems.

Senator CONROY—I want to ask you about the CEO/CFO sign-off. The CLERP 9 bill requires sign-off to the board on the financial accounts. However, the ASX corporate governance guidelines and the approach taken in the US go much further. Both require that the sign-off should say that the statement is founded on a sound system of risk management and internal compliance and control which implement the policies adopted by the board. I am not sure that NAB could sign that at present, but, putting them aside, in your view, should the CEO/CFO sign-off under CLERP 9 extend to a sign-off on the company's risk management procedures, especially in light of the current debate?

Ms Burke—That is a good question. Because the CFO/CEO sign-off already comes under the ASX Corporate Governance Council principles—it is in the integrity of finance reporting principle No. 4.1, and it is also referred to in principle No. 7 on risk management—I think that, in practice, it is moving towards that.

Senator CONROY—The ASX is saying to us that, in actual fact, the area causing the single greatest problem of compliance with these voluntary—and I do stress 'voluntary'—guidelines is this particular issue. If anything, the ASX is under enormous pressure to wind back its proposals, so I am a little confused. I am not sure that we are heading in the direction of compliance with this. In actual fact, I understand there is a strong backlash to try and move back and away from it. So I am not sure that, despite it being in the guidelines, there is actually a significant movement towards it. If anything, my understanding is that it is a case of significantly trying to walk away from it. The issue then comes back to whether it should be in CLERP 9 or not.

Ms Burke—The CEO/CFO sign-off was one of the proposals we put forward, just because we thought—

Senator CONROY—On the company's risk management procedures?

Ms Burke—On financial reporting. But I think that, in much of the reform with FSR and with all of the compliance, the trend definitely says, 'We are all risk managers now'—that is the saying. Whether you attribute that to the CEO/CFO and whether or not they can responsibly sign off on and certify to, it does put the onus on them. There are some great concerns about how that would work in practice and how to attribute the responsibility for that in relation to the sign-off.

Mr Marshall—It is interesting that there is a backlash on that issue for two reasons. First of all, while the board has overall oversight of the operations of a company, it is, of course, the executive team that knows what is happening. It is only the executive team that could really say that the procedures are being adhered to. On that basis I think the board would want to see a commitment from the executive team that the procedures are actually being followed. Secondly, when you look at other similar issues, ASIC has said that not only do procedures need to be in place but also the procedures need to be followed and should be seen to be followed. So the sign-off by a CEO or whoever is the responsible management team shows that procedures are being followed. Risk management, I would have thought, would be a standard requirement so the board has confidence that the procedures that have been put into place are being followed.

Senator CONROY—Ultimately, it is part of their job.

Mr Marshall—That is right.

Senator CONROY—Any thoughts on NAB?

Ms Burke—In relation to CEO/CFO sign-off, it depends what the CLERP 9 bill specifies as the scope of the sign-off.

Mr Marshall—You would have to ask why various people are concerned about signing off on a part of their responsibility.

Senator WONG—Yes, it is a pretty reasonable question, isn't it?

Ms Burke—Yes, it is an accountability measure. Given that the CFO reports to the board in relation to the financial reports and is signing off in relation to various processes—

Mr Neal—That is part of his job.

Ms Burke—Yes. It is systems based, I think.

ACTING CHAIR—That raises the issue of a point that you raised in your submission about qualified sign-off.

Ms Burke—Yes. Our issue was: if there is an auditor dispute and if it is qualified—this was just a fly-in-the-ointment question—what do you do if you cannot do a full sign-off? If it is

qualified in some way, it is more likely to be by the CFO. We just wanted to know if there was going to be any provision made for that, just on the mechanics side.

ACTING CHAIR—The Securities Institute obviously would like to see an incorporation of that as a matter of principle.

Ms Burke—We were raising that issue only because we wondered whether that had been thought of.

Mr Neal—Because, in reality, it is going to happen.

Ms Burke—We always adopt a stance of looking at practical issues. Although we look at a provision in theory, we try to think of it in a practical sense, so we asked, 'If there is a full sign-off, fine; but what happens if something goes wrong and there is some dispute and there is some qualification to the sign-off by either the CEO or the CFO?'

Mr Neal—And you can see a situation where you have got a new CFO in, who says: 'Oh, it's not what I thought it was. The old guy who was here before didn't do what I thought he would do. Heavens above, we've got all these problems to fix.' It is going to happen.

Senator CONROY—It's standard political procedure!

Mr Neal—If they have learned something—

Senator CONROY—'I've found a black hole'!

Ms Burke—With that comment, we were merely asking, 'What if?'

ACTING CHAIR—I want to ask about the issue of multiple directorships. Do you think that there is any actual argument that can be made for legislating a limit? If you do, what sorts of guidelines would like to see developed for setting that threshold?

Ms Burke—We did not comment on multiple directorships in the submission to the CLERP 9 bill, nor did we, I think, in the issues paper. It has been a side issue. We have discussed this with some other industry groups at times—who have some strong views on what is a feasible number of directorships that any one person can hold—and we have been mindful of the Higgs report in the UK in respect of that, which I think said three, with only one to be a chair.

ACTING CHAIR—So you do not have a strong position on it? You are just watching as an interested observer?

Ms Burke—We do not have a strong position. We defer to the professional associations who represent boards and directors in relation to that, but we are mindful of the corporate governance principles and, as in relation to some of the auditor engagement limitations, we are probably mindful of the fact of Australia's size and the limited pool of directors. So there are some very practical issues to consider there.

ACTING CHAIR—Because of the shortness of time, we have not really delved into the issue of conflicts of interest and their management. Have you got anything you would like to raise before the committee in addition to the submission?

Ms Burke—We would like to refer you to the submission we made to ASIC on the policy proposal paper on managing conflicts of interest that asked various questions in relation to applying the general duty to manage, avoid and disclose conflicts of interest to licensees under section 912, and in particular to the research report providers, given that they are our historical constituents—research analysts. We asked some very pertinent questions there and, because that has been an issue that the Securities Institute and the SDIA have been working on over these past few years, especially when we jointly issued *Best Practice Guidelines for Research Integrity*, it is an issue close to our hearts. What we very much endorse there is aspirational high-level principles of research integrity. But the comment that we did have in relation to looking at the PPP on managing conflicts was the extension of the general duty to provide financial services fairly, honestly and efficiently, which in the PPP became 'fairly, honestly and professionally'—a change of term.

Our feedback was that practitioners told us that they thought the duty to manage conflicts was already encompassed within that provision of providing advice 'fairly, efficiently and honestly'. Scott, would you like to say something about that? Our concern in relation to the CLERP bill was the classification of conflict categories. We were quite surprised that in the ASIC PPP they did not refer to the conflict category classification proposed in the CLERP 9 bill, so we could not see the association. We were disappointed that the PPP did not flesh it out and we were wondering how they would sit with each other.

Mr Marshall—That relates to the three classifications—

Ms Burke—Conflicts, and the description of financial and non-financial services.

Mr Marshall—Yes. It was left relatively vague there in some of the examples in how to handle those various potential conflicts within those three parts of the business. I will not add a lot more to that.

Ms Burke—The initial reaction of our practitioners was that they did not quite understand the first two categories, which were the ones which had the conflict management obligation attached to them, in the way it was phrased. They did not quite understand—

ACTING CHAIR—What the division was.

Ms Burke—what the division was, what the drafters were getting at in a practical sense. Wearing a financial versus non-financial services hat all the time and within the company and externally it was very confusing, and it could be assisted by some better examples and more examples so that it could be properly applied.

ACTING CHAIR—I want to quickly touch on the issue about supporting the G100 guidelines.

Ms Burke—The G100 guidelines in MD&A?

ACTING CHAIR—Yes. The ASX has had a fairly lukewarm reception to the introduction of these guidelines. Are you familiar with that and do you have a comment to make?

Ms Burke—Yes. We have supported the inclusion of an MD&A all these years—

Mr Neal—Forever, I suspect.

Ms Burke—in the directors' report and we see that as a very important component of financial reports specifically for shareholders, for retail investors, because those people might not be familiar with the complexities of the financial statements, and also for giving an opportunity for the company to make comment on its performance and future prospects. But we do understand that it has been a narrative analysis. It is probably not open to audit.

Mr Marshall—It would be very difficult to audit because of that. Also it is very important for the market to get a qualitative discussion by management on what they see to be the outlook for the company. But, having read some of the MD&As from the United States, it is possible to put in so much detail that the important information is completely hidden. So, from an analyst's perspective, I would say that the MD&A needs to exist but needs to have the important information highlighted and not to go into the depth that is forced in the United States because that is counter-productive rather than productive.

One of the issues we have today and the reason that I support this as a requirement is that there is a very broad quality of level of disclosure by companies. Some companies provide a wealth of information, and the banks would probably be the best example of that: 100 pages of supporting text by the management team. Other companies release only a paragraph or two of information to the market. Both of those are extremes and not the ideal solution. But if companies can be forced to provide commentary on the outlook for the company, those factors that are determinant of the outlook of the company and also why profit may have done certain things in the previous year, and if you can come up with a list of 10 or 15 major segments that the companies can choose from, that would be of immense value to the market—above the audited accounts, which quite often hide the underlying performance of the business and what is happening.

Ms Burke—Also, MD&A brings us into line with other capital markets which have similar provision. We see MD&A as an evolving issue. We did recommend that the quality and detail of the commentary in the MD&A be monitored or reviewed so that there are examples of what good disclosure is and what it is not, so it can continually improve over time. We suggested that the G100 guide, if it has to be amended, be incorporated in a schedule as some practical guidance. It is actually based on a similar UK guide. It has been recently overhauled, in April last year, and we took part in those revisions. It is just a matter of whether a guidance note would be issued perhaps by the ASIC or the FRC, whichever is the appropriate body to monitor how the MD&A is coming along, because we think it is a very important component of the financial reports for ordinary investors.

Mr Marshall—I might also just add a comment. We have seen several examples of where the guidelines are to meet industry best practice, whether they be for prospectuses or whatever. While the initial results have been good, concise documents—too concise, in many cases—as industry best practice evolves over the years, those documents very quickly become

overburdensome and again too large. I would not want to see a partition in the market with MD&A documents starting off too brief, go through a brief period where they are of adequate size and very quickly evolve to a size where they become cumbersome, like the US model at the moment.

Ms Burke—But what is important is the quality and reliability of the data in the MD&A—

ACTING CHAIR—Yes.

Mr Marshall—And the relevance.

Ms Burke—and its relevance and that it be reconciled with the data in the financial statements.

ACTING CHAIR—Thank you very much for coming along today. Your time is appreciated.

Ms Burke—Thank you very much.

[11.57 a.m.]

LONG, Mr Brian James, Chairman of Board of Partners, Senior Audit Partner, Ernst and Young Australia

ACTING CHAIR—Welcome. The committee prefers all evidence to be given in public, but should you at any stage wish to give any part of your evidence in private you may request that of the committee and the committee will consider your request. The committee has before it a written submission from Ernst and Young, submission No. 34. Are there any alterations or additions you would like to make to your submission at this stage?

Mr Long—No, but I might just make a couple of opening comments if you are happy for me to do that.

ACTING CHAIR—I invite you to make a brief opening statement.

Mr Long—I thought I should perhaps start by saying that the submission that we made on 17 November was, of course, made in regard to the exposure draft of the bill, and obviously some of the comments made in that submission are no longer relevant in the context of the bill as it is currently drafted. I am here as a representative of my firm, so the views I am expressing are not only mine but also those of the firm.

As an opening observation, for us at Ernst and Young—as is the case with the profession generally, I think—the restoration of trust and confidence in the financial reporting area is something which we are passionately concerned about. We are absolutely committed to a continuous improvement in that whole regime and to the rebuilding, if rebuilding is necessary, but certainly the enhancement—if it is not a total rebuild—of trust and confidence in that process. We do support the CLERP 9 initiatives wholeheartedly, and we think that the aspects of that proposal in the bill that enhance and strengthen the role of the independent auditor are very important. We see things like mandatory partner rotation as positives, and we fully support that. We recognise that a cooling-off period is necessary as part of that process of building trust and confidence.

We think the enhancements to section 311 are good enhancements—we are supportive of section 311. In reality, when section 311 was originally introduced, it was really quite a substantial benefit to those of us in the auditing business. It enabled us to have a dialogue at a different level with clients, encouraging them to do the things that they need to do vis-a-vis compliance with the law, if there are any issues that they need to address. So that was a tool that we have found valuable.

I suspect there may be some who feel that that tool is not used often enough, but I liken it to the iceberg effect. The times when the tool has historically been used are like the tip of the iceberg, and what you do not see, of course, is what goes on beneath the water. Speaking personally, as Chairman of the Board of Partners of Ernst and Young I spend most of my life with our major audit clients in audit work. What happens beneath the surface is the regular and strong dialogue that auditors have with their clients about their need to meet their compliance

obligations, their regulatory filing obligations or the various obligations that they have with the law. So there is a hell of a lot of use of section 311 that happens beneath the surface and is invisible—both to the regulator and to the community at large—that actively goes on within companies.

We support the establishment of the FRP and we think that it is a good move. We have made comments in the submission that the profession made about how the FRP should operate, and I am happy to discuss those if you wish. We support the general independence tests that are included in the legislation. We did participate with the profession in exhaustively reviewing the exposure draft and we made many suggestions, which I would put into the 'technical improvements' category, which enabled the draft to achieve what we believe to be its intended consequences or intended effectiveness. Many of those suggestions were accepted, and I think that the technical improvements that were made in the last iteration of the bill will be effective and yet are still consistent with the broad thrust of recommendations that were made in the HIH royal commission.

There are probably still some improvements that we would like to have seen and which we commented upon at various stages. We do support rotation of audit and review partners, but we think that there will probably be some onerous effects on some of the smaller firms, particularly in regional parts of the country. Western Australia in particular, I think, will probably feel the effects of that in the small-cap companies and the onus that is placed on them.

We also think that, while we recognise the limitation of ex-partners of the firm being involved on the board or senior management of audit clients of the firm, it is an issue. Our sense is that the limitation there is more reasonably limited to those who have been involved in the audit of that particular company—those who are involved in servicing that particular company. For instance, it seems to me that independence would not be impaired if a partner on the west coast of the country who was involved in delivering insolvency services, for instance, were appointed to the board of a client on the east coast. In reality I do not see that there is an impairment of independence, definitionally, by that person moving across and being involved in the board, whereas I recognise the point that, if someone were actively involved in the audit of a company either now or at some previous time, then that prohibition of more than one makes a difference.

Senator CONROY—Do you have any structure of the partnership and the allocation of bonuses, or the pool—

Mr Long—The profit pool?

Senator CONROY—The profit pool. Independence from the profit pool would seem to be the only way to satisfy that, even though the partners are on different coasts, if your remuneration is being affected by your partner's audit. How do you get around that one in what you are describing?

Mr Long—I think one of the pluses, if you like, of the legislation is that we have gone principles based and not rules based. If you are in a rules based system and you write a rule along those lines then it is rigid. If I were a partner in a small firm and I had six partners, your point would be legitimate. Whether I am a tax partner or an insolvency partner and my other two partners do the audits and they have three big audits clients and I know that my salary is

influenced by the fees that are derived by one or two of those big companies, your point is absolutely right. For example, my firm has over 300 partners, and I do not even know the names of all my partners, and many of them I would not recognise in the street if I walked past them. The reality is that the firm is of a size that no one account is so significant to the firm that it would affect our numbers in any significant way. We could lose an account or we could gain an account; it does not change our numbers that much.

ACTING CHAIR—It is an issue of materiality, basically.

Mr Long—Yes, it is a materiality issue. It becomes not relevant.

Senator CONROY—But independence is a tougher test than a materiality test.

Mr Long—It is.

Senator CONROY—The real world crashes in here at this point, trying to find a balance between pure independence and materiality.

Mr Long—The last observation I was going to make is that I am a little troubled that the whole debate around audit quality has concentrated almost entirely on the question of independence. As we all know, there are two types of independence: actual breaches of independence and perceptions of it. I think, Stephen, you are talking about the perceptions. I agree that perceptions are almost as important, if not as important, as an actual breach. As a profession, we have had no trouble whatsoever in dealing with actual breaches. Have there ever been actual breaches? Probably, because we are dealing with human nature and things will happen that you would prefer did not happen. The firms have very rigid rules. We almost do not need legislation; we do not need professional standards. The firms are so substantial on a global basis that they have rules which are higher than the professional standards and higher than the regulations. Actual independence is not an issue; perception is.

There are two types of perception: one that is born of knowledge and understanding and one that is absent of those. That is what I call the lowest common denominator of perception. That does not mean you ignore it, but the one that is most important, I think, is the one that is born of knowledge and understanding. That is constrained to a limited number of people because not everyone has that knowledge and understanding—typically, it is the board that has that. While you are right to say that there is a materiality issue, and it is quite different when you are thinking about independence because you are dealing with perceptions, nevertheless we should not just go to the lowest common denominator. I think quality audits will dictate the success of my firm and the success of all the others that operate in this area. Independence and objectivity are fundamental and they are a given that we all need to maintain, but quality audits are more influenced by other things than just that—it is not that alone. Focusing enormously on the independence question is not going to cure what everyone is really concerned about, which is trust and confidence around the quality of the audit process.

What will affect the quality of the audit are the state of mind and the objectivity of partners who are involved in the delivery of the audit services—state of mind born of a value system, of culture that you build within organisations and of knowing what is right. The fact that you may participate in providing additional services, for example, to an audit client is not going to

influence that objectivity if the culture and the value systems are in place. What also influences the quality of an audit is the quality of the people that we are able to recruit. A vibrant, strong firm of this type is important. I think size is a virtue in producing quality work, because you do not become dependent upon a particular client or even a group of clients. It means you can attract high-quality people into the firm and reward them. You cannot attract high-quality people if there are too many barriers to their career or to their opportunities for success: barriers that come if we went in a completely draconian way—and no-one is suggesting it, but if it were suggested—and said that audit firms should do audits and that is all. By doing that, you might address the perception of independence. But it is at that lowest common denominator, not at what I think is where rubber hits the road. You would address the perceived independence but there is nothing surer than that the quality of the audits would drop off.

You need to have people with IT skills; you need to have people with corporate, finance and evaluation skills; you need to have people who understand financial instruments and the complexities of them; and you need to have people who understand all the implications of tax in an accounting sense. A pure accounting firm or a pure audit firm simply could not afford to have those resources unless they were part of the firm. So we will attract high-quality people if we can give them job opportunities and a future. Some of the things which were in the original bill—and I have spoken about this before—were moving towards making a career in a professional accounting firm less attractive rather than more attractive, and there were barriers being put in place. Some of the restrictions on what you could do when you left the firm and the like were, I think, going to be counterproductive. I would prefer the force of law to be applied in a different way from that contemplated; nevertheless, strong auditing standards are more important than the fact that they have force of law. Strong auditing standards will drive the behaviours and the quality of what is done.

Picking up your point, Stephen, yes, there is a materiality issue but I do not think we should lose sight of the main game, and that is allowing firms to be strong to attract good people and to put in place the systems with the capability of running training programs to support the development of auditing standards. That will do more about generating quality audit work in the future than a focus on the impediments. They are both important but I think it is a question of balance.

Senator CONROY—Do think you can audit your own work?

Mr Long—Absolutely not.

Senator CONROY—Part of what the committee is trying to get a handle on is what areas you think are important. I appreciate what F1 says, but what are the areas? There seems to be a couple, like evaluation—

Mr Long—Clearly, evaluations. This is why I mention principles based rather than rules based work. It would be no good all, I think, to have a set of rules that say, 'Auditors should never provide tax services to audit clients.' I do not have any problem whatsoever, though, with the principle that you cannot audit your own work. In fact, this morning I came from a meeting with a client who is about to undertake a major capital transaction where I said, 'Guys, you now need to go out and get some independent tax advice around this area because I will not let my people do it. I have to give an opinion on that in a document that is going to the market, so you

have to get someone else.' They then commissioned the extra work. I cannot objectively form a view about something that relates to a complex tax structure or arrangement which could have financial implications should there be adverse outcomes—things go differently to what was intended—if my partner has put all that in place. But I do not have any problem at all with my tax partner doing compliance work or some other things, because I do not have to form an opinion on that. It is where the balance comes in. Evaluations are an absolute given. We would never—

Senator CONROY—Tax is a tricky one. As you would be aware, 14 states in the US have just gone after Wilcon on the basis that they are saying KPMG advised them on how to design tax avoidance structures. They are asking how you could then audit that work.

Mr Long—That is my point—I agree with that much—but I do not think it is black and white. There is an attractiveness about saying, 'If you just say you can't do it then you won't have a problem.' But I am not sure that is the right answer for many corporations that find there are benefits in using an audit firm because they have knowledge of the organisation. There are benefits because there might well be a lower cost in doing that exercise—if you are not in truth impairing the independence. I fully support highly transparent disclosures about what the auditor has done. In a lot of the companies I am involved with we always lay out a lot more detail about what work the auditor has done. The fresh air of disclosure is as good a disinfectant as any in helping people form a view or even develop a perception about the independence. If you see that they have done other services and you know exactly what they are, you can form a view about whether you have a problem with that.

The financial bit is one of the reasons why you might. There is a lot said about auditors accepting audit engagements so that they can sell other services, but there is not much said about why, if they are concerned about the finances, they would not be concerned about the audit fee itself. If earning additional fees is likely to interfere with their behaviour as an audit partner, why wouldn't the fact that they get paid to do the audit interfere with their behaviour as well? There are plenty of audit clients where the fees are millions of dollars and there might be a million or two for other services. If this is going to interfere with their objectivity, why isn't the base fee going to? As soon as you start paying your auditor, you go immediately into a situation where someone might perceive that they are not being objective or they will not be independent, because they are trying to protect the audit fee. I think that argument runs just as effectively there as it does over here, and my point is that the firms, and the larger firms in particular, are not reliant on one client. We would never jeopardise our independence for the sake of a fee.

Senator CONROY—But Andersen would have said that too. Andersen Worldwide were not dependent on Enron, yet they allowed themselves to be completely corrupted by one client. Ultimately, it led to their destruction—as you would know, as you picked up Andersen at an Australian level.

Mr Long—When I look at what we picked up at the Australian level, by and large the people subscribed to the appropriate value system and to the appropriate culture. Did they have a problem here and there? Yes, they did. They are not the only ones, but they did. I cannot speak about their overall culture, but I would be prepared to acknowledge that something went wrong there. But I think it went wrong with the leadership, and no amount of laws was going to change that. There are plenty of laws that discourage behaviours in a particular way but do not stop

those behaviours. As I said at the beginning, we fully support continuous improvement, and I think that is just one aspect. All the firms have gone to school on Andersen, if I can put it that way.

Senator CONROY—I am very conscious of the argument about wanting to provide career paths and that if you narrow down options good people are not going to come into the industry. There are a lot of people over the age of 50 in the industry. Hopefully I am not doing you a disservice there.

Mr Long—Well over!

Senator CONROY—You were attracted to the industry long before the consultancy type spin-offs happened. Almost all of the senior people that I meet nowadays came into the industry long before these incentives existed. When people say to me, 'We need to get good people,' I look at them and say, 'But you're a good person. You're highly talented and internationally mobile. You can work anywhere, and you chose to go into that industry in the first place.'

Mr Long—Let me use myself as an example. I entered this business straight out of high school in 1966. But I would not still be here today if this job had not provided me with the career challenges and opportunities which it has done because the profession has grown and because my firm has grown. If it were still what it was when I joined, I would have left long ago. So it is not only hiring and attracting; it is also retaining. My point is not that the fact that we provide these other services makes it more financially lucrative; that is not it at all. That enables the firm to grow. It is more that there is variety and there are options.

A lot of double degree graduates come out of university and they might come into the auditing business, for instance. But the fact is that they see a potential career in the corporate finance area, with an ultimate career being with a Macquarie Bank, UBS or somewhere like that. They see an opportunity to go from audit to tax as a career opportunity. Most of the graduates we hire do not have the view that they will be staying for the duration. Most of them say, 'I'm here till I get my professional year qualifications and I become a CA, and then I'll figure out what I want to do.' Along the way, they have all of these options open to them, and they will choose the one which is the most attractive. If they see that opportunities in the accounting firms are narrowing, rather than broadening or at least staying broad, they will jump in another direction. We, as firms, will be the losers through the loss of that talent, but I think the business community will be the losers in the long run, because there will not be people with the skills that are needed to audit the increasingly more complex businesses that we have.

Senator CONROY—I did not want to interrupt you—I might have interrupted you before you finished there.

Mr Long—That is fine. They were the points that I wanted to make. Least of all would we be denying the importance of objectivity and independence. It is simply saying that there is more to it than that. There are lots of other things which are as important, but more of them, which will influence the quality of the audit. It is those characteristics that are important: the best people, the best systems and the knowledge that we have to invest in will do more for ensuring that we do not have audit failures. Will we have them? Possibly. I am not going to sit here before you guys and say there will never be another audit failure because we have fixed everything—that is

not realistic. What we are about is diminishing the opportunity for that and putting in place the failsafe systems. My point is: stopping audit firms from selling other services to their audit clients will deal with that perception but it will not necessarily solve anything else. It may in fact be the cause of a problem and it introduces lower flexibility for corporates.

Senator CONROY—I just want to talk about a few specifics rather than general issues. Yesterday—and I think you are conscious of this—ASIC released three guidance papers.

Mr Long—Yes.

Senator CONROY—One paper related to new auditor registration and the second paper related to auditor and financial reporting obligations. Have you had an opportunity to look through those, even though they only came out yesterday?

Mr Long—They did, and unfortunately I have not read through them, although I have glanced at them and had a discussion with a few people about them. The one I can speak to particularly is 311, because I focused on that.

Senator CONROY—I wanted to talk about the auditing and financial reporting obligations, which I think you are right across. It provides guidance in relation to when a suspected contravention of the Corporations Act is significant and therefore should be reported to ASIC. Do you agree with the approach taken by the guidance paper and the CLERP 9 provisions on this issue?

Mr Long—I agree with the CLERP 9 provisions. Regarding the guidance paper, I am glad to see that it is an exposure or discussion paper, because I think it needs some work. I think there are some areas in the discussion paper that talk about what is significant and what is not significant, and I am troubled by that. I think there is a catch-all that says, 'If you're not sure if it is significant, tell us about it anyway.' I think the core skill of the auditor is exercising judgment, and I do not think ASIC in their discussion paper should seek to distract the auditor from the responsibility of exercising judgment. The law is saying, 'If there is a significant breach in the law, you need to tell the regulator about it.' Clearly that is right.

What I think is proposed in the discussion paper is that for the purposes of guidance 'significant' means, for instance, that there is an entity regularly breaching. You could be a bank—I hesitate to say 'bank', but you could be a bank—where breaches of law can happen on a regular basis. But there are systems in place to identify when it happens and deal with it. I would not see that as significant. If the individual events are not significant and an organisation has a process to deal with them in an effective way, I think it is counterproductive. I do not see what is gained by the auditor trotting along to the regulator and saying, 'Oh, by the way, did you know that on 20 occasions this organisation did this, that or the other?' I agree with the principle: if it is significant, there is a responsibility to report it to the regulator because it is significant. Even though their definition of 'significant' implies that a sequence of events is, by definition, significant I do not think I would agree with that.

Senator CONROY—Suppose your bank regularly breached its risk management provisions and limits? Each individual breach would not be significant.

Mr Long—No. That is not a breach in the corps law, though.

Senator CONROY—No. That could be an APRA reporting issue rather than an ASIC reporting issue.

Mr Long—Correct, and again it is important for the auditor to exercise judgment. To pick up the hypothetical, if the bank had breached the risk systems, I would think that is very serious. In the case of a bank there are tripartite arrangements between the regulator, the auditor and the company, and that stuff gets surfaced and it should get surfaced. You would not go past that without writing what we call a management letter, and the regulator gets to see the management letter. So I think those things should be covered.

What ASIC is talking about of course is Corporations Law breaches, which could be something as insignificant as a case where you should have filed the financial statements on a particular date for one of your lower level subsidiaries, and you did not; you missed it by two days—or by a week, for that matter—because the director was out of town and no-one could sign them. That could happen. The client could have hundreds and hundreds of companies and could have missed the date 20 times. Again, there is no significance in that, necessarily. The accounts will get filed—they need to be filed—but they may miss the deadline by a little bit. I would prefer that they did not, but if they have filed it three days late I do not see any point in the auditor going to the regulator and saying, 'Did you realise that these were filed three days late?' I do not think that adds anything, whereas the guidance would imply that it does.

Senator CONROY—Professor Ramsay says that the provision is designed to get audit firms more proactive and to have in place systems to detect breaches of the Corporations Act. He is also quoted in today's *AFR* as saying that if such a system was working:

… it might be that the things that occurred at the National Australia Bank might have been picked up earlier. It will create a culture of proactive investigation … it turns auditors more into watchdogs. This [Clerp 9] now has some bite.

Mr Long—Again, I think the thrust of that is heading where ASIC is heading. I would not necessarily subscribe to that. The principle is true. As I mentioned earlier, I think 311 has given auditors bite. That always has been there. It is that 'tip of the iceberg' issue. What Ramsay does not see is the things that do go on. I think the existing provision gives the auditors the bite they need.

Senator CONROY—Are there any other issues out of that paper that you would like to mention?

Mr Long—No, I think that covers it. They are the main things. As I say, we do not have a problem with that part of the legislation. What I said to a journalist yesterday, which was repeated in the press this morning, was that the best audits are done when the auditor is inside the tent, if I can use that term—where there is an open communication between the audit client and the auditor. Those doors will close if the auditor is in a position where, by regulation, they have to report to the regulators every tiny, insignificant type of incident. The doors will close. That was our main concern about the original drafting, where it said that within seven days you have to report to the regulator. In seven days, companies do not have an opportunity of correcting things in the normal course, which they normally to.

Senator CONROY—In the CLERP 9 bill, do you support the obligation for an auditor to report to ASIC the circumstances where a person tries to unduly influence, coerce, manipulate or mislead a person involved in the audit?

Mr Long—I do, but I do not think I have ever done an audit where a client has not attempted to influence me. So the word 'unduly' is definitional.

Senator CONROY—There is a strong legal definition, I would assume. You and I might quibble about it, as non-lawyers—I assume you are not a lawyer—but in a legal sense—

Mr Long—They can find their way through that, yes. Unfortunately, I am not lawyer, so therefore I am the one that is going to breach the law if I do not report it.

Senator CONROY—No; it is very fortunate that you are not a lawyer!

Mr Long—Clearly the clients who behave in that way are the clients that we would prefer not to have as clients, to be honest. But to suggest that clients do not put their points of view vigorously and strongly would be wrong, and I do not think there is anything wrong with that, frankly. Our job is to hear what they say, and to stiffen our back and our resolve if what they are suggesting is wrong. That is a natural dynamic.

Senator CONROY—What about the requirement to report to ASIC circumstances which amount to an attempt to interfere with the proper conduct of an audit? Is that again a definitional issue, or something where you would have a problem with the principle?

Mr Long—Again I think it is definitional. I do not have a problem with the principle, because again ultimately the auditor is going to say to the regulator, 'I can't perform this audit.' You would go through the board first, but if the board and management were all behaving in that particular way then ultimately you would go to the regulator—because you cannot resign. The natural recourse would be to go to the regulator to say, 'I can't exercise my job here because of what is transpiring.' Again it is definitional. Those words imply to me very extreme cases, and our internal systems are designed to prevent our objectivity being lost because of the behaviour of a client.

Senator CONROY—I want to move on to the Financial Reporting Council. Do you support the proposal in the bill for the FRC to oversee auditor independence requirements in Australia?

Mr Long—Yes, though I am not sure how you would do that in isolation. I would prefer to see, frankly, that the FRC oversee audits, period. I talked earlier about audit independence and audit quality, and I do not think you can separate those things—they are naturally linked and equally as important. I would prefer to see the FRC overseeing both, to be honest.

Senator CONROY—The Stock Exchange state in their submission to this inquiry that the primary function of the FRC should be oversight of audit quality, of which auditor independence, they argue, is an aspect.

Mr Long—Correct; I would agree with that.

Senator CONROY—Okay. In your view should the membership of the FRC be expanded?

Mr Long—Beyond what it presently is?

Senator CONROY—Yes, I guess we could start there. Somebody who knows something about audit or accounting on the FRC would be helpful.

Mr Long—I suspect that the membership is too big right now. I think if it had that broader task of overseeing audit quality then I would probably think about reconstituting the FRC with people with the relevant skills and probably make it a smaller body, to be honest, and take away some of the interest groups. If it had the task of audit quality, then I think that would need to be the case.

Senator CONROY—Professor Ramsay has advised the committee that the FRC has no representation from groups representing the public interest, which comes a little to the issue you mention. He said:

I do see an important role for the public interest and I am not quite sure where that is when I see the current FRC membership—

I have some sympathy with his view there—

In my report I also made an observation that, in terms of representatives of the public interest, one should give the thought even to public advertisement. The relevant minister might want to think about advertising, and choose the best qualified people on the basis of public advertising. I know that is not the current process but, again, I think these sorts of initiatives may be worth thinking about to ensure that you do have the best possible pool of people to choose from.

I appreciate the comment you made about interest groups, but do you think a future FRC should include representatives of the public interest, or should it contain technical boffins—and that is not meant to be a pejorative term?

Mr Long—I understand. I think it should be a balanced group. I think that the group is probably too big. I think it should be a group with complementary skills—so there is someone who has the accounting background, the auditing background, the investment community background and backgrounds in some of the other areas that I think need to be represented.

Senator CONROY—What other changes need to be made to ensure that the FRC is operating in a transparent and accountable manner? For example, should the secretariat of the FRC be provided by Treasury?

Mr Long—I am not sure I have a view about that, Stephen. I would be more interested in getting the role of the FRC more clearly defined and refined. Once you have established what their job is, then I think what flows after that is a natural consequence.

Senator CONROY—My next question is: how do you think the role of the FRC in relation to overseeing auditor independence differs from the role of the Public Company Accounting Oversight Board in the US? I guess that is a little hard to answer until we have clearly defined

what the role is. Do you support the proposal for the FRC to oversee auditing standard-setting arrangements?

Mr Long—I do, but that is why think it is so strange. Here you have the FRC overseeing accounting standards, auditing standards—

Senator CONROY—It is actually not meant to be overseeing accounting standards. It actually thinks it is the accounting standards setter—that is one of the problems in the country at the moment.

Mr Long—It oversees the Accounting Standards Board and the auditing standards board, yet there are other things which fall outside of it. If you are going to be responsible for the accounting standards then you should be responsible for looking at all the aspects of accounting standards—for example, the FRP is outside the FRC.

Senator CONROY—My next question was: should it look after the FRP as well?

Mr Long—Absolutely. I think there is a risk, frankly, of the FRC having this oversight responsibility of the Accounting Standards Board and then you have the FRP interpreting the standards. The interpretation could well be at odds with what the Accounting Standards Board contemplate when they promulgate the various rules. I think that is dysfunctional, frankly, because whatever the FRP decides could well become part of case history, if you like.

Senator CONROY—That is one of the problems. No-one really understands how this is all going to work in 12 months, when we have international accounting standards and the IASB determines these matters. Where does an Australian FRP or even an AASB or an urgent issues group, or whatever, fit as an interpreter of an international accounting standard? Ultimately no-one is going to care what the FRP says. Ultimately these issues are going to have to be determined at the international board level, because you cannot have an interpretation in Australia that is different from an interpretation in Europe or Japan. How is this going to work in practice? While the FRP sounds excellent and I generally support it, my worry is how the hell we are going to make this fit into this international model, where we are largely irrelevant.

Mr Long—One of the realities is that there is no capacity for the International Accounting Standards Board—or anyone else, for that matter—to promulgate a definitive set of interpretations to cover every possible circumstance. You just cannot do it—there are too many things. Necessarily, judgment will be exercised by financial statement preparers and by auditors about how a particular set of circumstances in a commercial environment fit into the model and whether there is either an interpretation or an analogous set of circumstances which should be used as the guidance to treat this particular accounting problem. That is where the FRP will come in: there will always be a set of circumstances which do not exactly fit the rules that have been written or the guidance that has been provided. Therefore there is interpretation on the run, if you like, or in real time.

Senator CONROY—Given the lead time to try to get the IASB to look at anything—I am not being pejorative when I say that—you could have the FRP making decisions, as you said, and case law comes into play over 12 to 18 months and suddenly the IASB says, 'No, that's a wrong

interpretation.' If a court decision is made based on an FRP ruling and the IASB says, 'No, that is the wrong interpretation,' what the hell will happen then?

Mr Long—And you have the IASB giving choice in some of their standards.

Senator CONROY—Not if I have anything to do with it.

Mr Long—So there are real issues in the practical application.

Senator CONROY—Thanks for that. Can you advise the committee of your preferred model for funding of the FRC in light of the failure to obtain corporate donations? Have you any thoughts?

Mr Long—The FRC is there to deal with the high end of the listed companies primarily, and I would have thought that some sort of levy system—

Senator CONROY—The top 300, say?

Mr Long—Something like that, yes. You get the ASX to collect it when they collect their listing fees or you stick it onto the company registration process or have some mechanism like that. That is how I suggest it should be funded.

Senator CONROY—Should the FRC hold its meetings in public? I would like to go and watch some of their debates at the moment but I am not allowed to.

Mr Long—I think so. Transparency in those sorts of processes is helpful.

Senator CONROY—I appreciate that there will be some issues where—

Mr Long—You might close the door.

Senator CONROY—Yes.

Mr Long—But there should not be anything to hide in those sorts of discussions, and I think it would be helpful for them to be more open.

Senator CONROY—I am sure you are familiar with Keith Alfredson.

Mr Long—Yes.

Senator CONROY—He suggested that, before the FRC is given additional responsibilities, the Australian National Audit Office should perform an audit of its activities with particular emphasis on the FRC's governance arrangements. Keith has been a member of that body for a long time.

Mr Long—He probably has more knowledge than I do about the sorts of things he had in mind when he made that suggestion, so I probably cannot add to that.

Senator CONROY—I want to talk about auditing standards, which we have covered a little. On the move to international auditing standards, your submission says that Australian auditing standards should not receive legal backing.

Mr Long—Auditing standards, yes.

Senator CONROY—Existing Australian auditing standards should not receive legal backing.

Mr Long—Yes.

Senator CONROY—What is the benefit of Australia adopting international auditing standards?

Mr Long—I think it is similar to the benefit that you have in adopting international accounting standards, and that is that when you go to capital markets, wherever they be, there is a common base of standard to which the financial statements have been, firstly, compiled—international accounting standards—and, secondly, audited. You can expect an audit done in Australia to be comparable to an audit done in the United States, the United Kingdom or Germany, for example. International auditing standards are a positive step as part of a process of getting to a high and consistent level globally. That is helpful to companies that have access to global capital markets.

Senator CONROY—Do you think it is in the best interests of Australian shareholders that Australia adopt international auditing standards?

Mr Long—Yes.

Senator CONROY—Are all of the international auditing standards a higher quality than existing Australian auditing standards?

Mr Long—No, I probably would not say that—any more than I would say that Australian standards are higher than international ones. Australian standards are in a continuous improvement mode and have been for many years; international standards are the same. When we go to international auditing standards I do not think we will be stepping down, but I do not think we will be necessarily stepping up enormously either.

Senator CONROY—The international auditing standard process, though, has been in disrepair for a while.

Mr Long—That is true.

Senator CONROY—Back in 1998 we tried to move to international accounting standards and at the time there was a lot of legitimate criticism that the IASB was a pretty tame body—whereas now you have Tweedie, you have got a board, you have got a lot of market cred around the IASB. I am not sure you could point at the international audit standards board and say that it has that same cred.

Mr Long—I think that is a fair observation. I think, historically, that has been the case. What I am encouraged by is that that is recognised. As much as the international accounting body has stepped up the curve, so has the auditing standards group. It is a project which needs the effort that has been put into it.

Senator CONROY—The joint submission from, I think, the CPA-ICA—which has the general support of all of the big four, if you like—recommends that if legal backing does occur then the auditing standards should not be disallowable instruments. Could you advise the committee why they should not be disallowable instruments—and I am sitting in the room!

Mr Long—My view, and what is expressed there, is that the purpose of having auditing standards with the force of law is primarily so that there are teeth that can be bared if there is a breach of the auditing standards; it is an offence, if you like, to breach the standards. I think that is achieved equally by having, for example, incorporation of auditing standards by a single line in the law. What you get with that is the nimbleness of being able to make changes to the framework, without losing the force of law. So if we are in international harmonisation—I agree with your observation earlier that that needs to be at the right level, and it is getting there—when international standards change, they can be adopted and incorporated in Australia, just like that. Whereas if it is a disallowable instrument then there will be that process.

Senator CONROY—So parliament should just be a rubber stamp? A law is a law and parliament's job is to debate laws and discuss laws whether they are in the form of regulations or not. So we should just trust our betters?

Mr Long—I think you should trust the system that you put in place. If you put in place the FRC and appropriate standards boards to deal with it, they are the people who have expertise in those areas and it is a reasonable piece of trust to place.

ACTING CHAIR—It could be described as delegation.

Senator CONROY—The High Court has got lots of views on delegation. I would say to you that the FRC's powers were a matter of heated debate in 1998. I have said publicly before that I think they have acceded their powers. They have a committee secretariat that is run by Treasury, which is the direction of government. The government have interfered extensively on the timing issue on the adoption of international accounting standards. I do not think any of the above is particularly controversial. Senator Ian Campbell stood up at senate estimates—and I think you have heard me say this before—and said, 'We did a deal with the ASX: give the FRC money only on the basis that it delivers an outcome on international accounting standards by 2005.'

So there is not a lot of independent integrity in that process at the moment; that is a highly political process. I appreciate your point: there is a process and parliament should accept the process. My problem is that I did not accept the process at the beginning and I have been a constant critic of it since 1998. If you check the flow of the Senate debates—hopefully you were not paying attention at the time!—you will find that in 1998 we sought an amendment to stop the FRC directing the AASB and we opposed that power. It has been a downhill slide since then, unfortunately, in terms of the independence of the process. Regarding disallowable instruments, I appreciate the point that you make about flexibility and that it is something you seek. Despite

the best efforts, the government's mismanagement of the Senate process wins out. It is a terrible thing to watch at times.

ACTING CHAIR—Have you got any further questions?

Senator CONROY—I do. I will move on. I am just teasing, Steve. Keith Alfredson has made a submission to the committee, which says:

...there is a need to differentiate between the technical Board of the AuASB and the statutory body.

Keith proposes that the AuASB should be the employing body but that the staffing to the AuASB and the AASB should be merged into a new entity called the Australian financial reporting and assurance institute. He says that this body:

... could provide the technical and administrative support to both the AASB and the AuASB.

He is concerned the current structure will not attract high-quality professionals:

... as technical experts tend to wish to work in a collegiate style as part of a larger group, so ideas can be shared...

Do you have any views on those comments?

Mr Long—I understand what Keith is saying and I think, frankly, there is merit in it. If you get a collection of people together who have the standard executive role—if I can put it that way—then I think there could well be pluses in that and possibly efficiencies.

Senator CONROY—Regarding the financial reporting panel—and you may have heard me asking the previous witnesses about this—Keith made a submission about the role of the FRP and the pre-dealing with issues. He said he believed it would:

... undermine the independence and professionalism of auditors and could become a process for allowing auditors not to have to make the 'tough' decisions.

Do you agree with that? If you do, why shouldn't auditors be required to make the tough decisions themselves?

Mr Long—I think they should. I have considered FRP and whether I would be comfortable with the pre-panel. My general sense is that, properly structured, it could work, but it could only work if it was binding. It is not uncommon for an issue to come up—this is in one of those areas where the rules are not necessarily clear—where it is in everyone's interests to be absolutely sure that, when you go forward and report on a particular basis, no-one is going to come along later and attack what judgment you have exercised. So I can see it as a plus. We have all seen restatements of financial results in the US and the enormously detrimental effect on shareholder value whenever that happens, way beyond the event itself in many cases. If there is a chance of preventing that, I think it is a positive thing. But it would be nonsense to have a pre if it was not binding on the regulator and everyone else.

Senator CONROY—Just going back to that issue, the parliament may set it up as binding. How do you then have the interaction with the IASB and its processes? How can the FRP be binding on interpretation of accounting standards when the body that actually makes the decision is international? I know we have talked about this, but I am fascinated by how we can actually make this practically work.

Mr Long—I think in this way: the reality is, with all the interpretations in the world that the internationals put out, the auditors still have to exercise judgment. So do the financial statement preparers. You have to take the set of rules and the guidance and the interpretations and apply then to a fact pattern. The preparers do it and then the auditors come along and say: 'You know what, I think you missed that. That's not the way this is properly interpreted; this is how it's properly interpreted. You have the potential for conflict.' So the company says, 'We think this is right,' and the auditor says, 'I'm not going to sign off on that basis,' and you either finish up with a qualified audit report, which helps no-one, or you have some sort of strained compromise in the accounting, which helps no-one. Your question is: how can the FRP exercise judgment in the same way the auditors do right now? We have to exercise judgment.

Senator CONROY—Yes, but, if it is binding, it is a slightly different level. If it is non-binding, at least it does not create the case law, I guess, in that sense—

Mr Long—No.

Senator CONROY—that can be potentially overruled. Anyway, I will move on, because I am not sure that you and I can resolve it here today.

Mr Long—I understand the point you are making, but the reality is that sometimes you have to make—that is why the UIG was formed, because there are practices that operate—

Senator CONROY—But then the board kept overturning the UIG.

Mr Long—Yes, but the principle was that, where you have got diverging interpretations of practices and you have not got time to write a formal interpretation, you have got to make a call. It is better that we have consistency, even if it is slightly at odds with what the accounting standards guy said.

Senator CONROY—'True and fair' is something I think you raised in your submission. Sorry to keep quoting, but Keith made a submission to this inquiry where he rejected a recommendation of the Joint Committee of Public Accounts and Audit, which is a separate committee to this one, but it is a committee that I did sit on, although not for that particular inquiry. That committee made a recommendation that the directors' report should set out the directors' reasons why compliance with accounting standards would not result in the financial statements giving a true and fair view. Keith said that financial reports must stand alone and that to include the same information in the directors' report, which is not audited, will lead to unnecessary duplication and possible confusion. Do you have a view?

Mr Long—Absolutely. I agree with that.

ACTING CHAIR—The JCPAA is a good committee.

Senator CONROY—It is a very good committee, and I have spent some time on it.

ACTING CHAIR—I am on it.

Senator CONROY—Mr Long, you possibly heard some questions to earlier witnesses about CEO/CFO sign-off.

Mr Long—Yes.

Senator CONROY—Essentially, I am looking at the difference with the ASX corporate governance guidelines, which are voluntary, in terms of it being mandatory for CEOs/CFOs to sign off; CLERP 9 does not go that far. Should it be mandatory for the sign-off on the risk management and internal compliance and control systems? I think you might have heard a bit of the discussion, and that seemed to be the area of the greatest backlash out there in the broader community against this. That one guideline is causing the most angst, I am told by the ASX people, and there is a lot of pressure on to walk away from that.

Mr Long—I think it would be a mistake to walk away from it. My personal view is that the sign-offs make sense, and I would not be troubled if that were incorporated in the law.

Senator CONROY—I want to talk about operating and financial review, otherwise known as the MD&A. The CLERP 9 bill requires the preparation of an operating and financial review. The explanatory memorandum says that G100 guidelines may be used for the purpose of satisfying the legislative requirements. The ASX submission states that the provision should be more specific and should require a list of topics to be discussed. What is your view?

Mr Long—I think the G100 guidelines are really quite helpful on the MD&A. There is a real tension—and I did hear some of that discussion here—between too much and too little. Clearly the MD&A that we see on the street currently is not enough and is inadequate. I think the G100 guidelines help out, and there is probably some improvement in enunciating exactly what should be in the MD&A. I think there is scope for that, but I would not want to take the art out of it, because once you put rules in for those sorts of things you end up ticking the boxes and it is not necessarily productive. There is an art in MD&A—as there is, frankly, an art in drawing up financial statements and their footnotes. The objective is to communicate. If people keep sight of the overall objective, it is to enlighten people not to conceal. That is the primary plank. We could have some more guidance. As I said, G100 helps in what they have said. I would not be comfortable, I think, with a set of rules that say the MD&A must do A, B, C, D, E and F.

Senator CONROY—Thank you.

ACTING CHAIR—Mr Long, you have been most gracious with Senator Conroy, despite some of his very ungracious comments! I have one question, just to touch on something that a witness raised this morning, and it is to do with the quality of audits and concerns that were raised that there has been an erosion in the principle of civic service and social service in the role that auditors undertake. Specifically, concerns were raised about the ability for incorporation. At the very beginning of your comments you touched on that notion of audit behaviour and considerations that are brought in with regard to audit behaviour. Do you have any rebuttal that

you would make about the formation of incorporated audit entities and any influence that that may have on behaviour—or do you think that is an entirely separate and distinct legal vehicle?

Mr Long—I think it is a distinct issue. Do you mean incorporating audit firms so that they have a different accountability?

ACTING CHAIR—Yes.

Mr Long—I do not think that goes any way to addressing the issue. With regard to the way in which businesses presently operate, their success and the quality of work they produce are dictated by the culture, the value systems, the organisation and the things that are rewarded in those organisations. Organisational structure means nothing if the behaviours are not aligned in a particular way. We spend more time in our firm thinking about how we encourage the right behaviours—enunciating value systems, espousing them and testing whether they are being practised, and making sure that the culture is there to do the right thing in terms of fairness and objectivity and encouraging that right through our organisation. That is what will make a difference. Organisationally, I do not think you will fix anything.

ACTING CHAIR—I am sure that is the case, but it does not address the Arthur Andersen situation which arose. I happen to be on the public accounts and audit committee and this is an issue that we turned our minds to on that committee as well. There is evidently the opportunity for certain kinds of behaviours, although they may be considered unprofessional, to arise. Do you think the CLERP bill—and obviously you made comments supporting partner and firm rotation and so on—provides safeguards that, whilst not providing an absolute guarantee, go far enough, or perhaps too far, in trying to dissuade partners or firms that might engage in the kind of behaviour that led to the collapses we saw?

Mr Long—I think CLERP 9 helps; the public debate helps. But what is having the biggest impact is the fact that the four major accounting firms around the world—or six if you include, as you probably should, the other two global firms—have had visibility of what happened at Andersen. I can assure you that, in terms of behaviour, the focus of organisations is on risk management, fail-safe systems and quality being the fundamental premise. If ever it needed to be underlined or emphasised, I think the Andersen incident has done that. I express the view—and I am sure that others in the major accounting firms would express a similar view—that culturally we have always had a system which does not allow individual partners to behave in a way that jeopardises a firm. It will happen—of course, you will always have a rogue—but we have a system where the leadership are interested in the long-term survival of the firm. Arrogant behaviours and like are not part of the culture. If ever we needed that underlined, though, the events of the last few years have done that. We have continuously improved. We have moved to a place now where I think there are absolute fail-safes, and the culture of quality is so deeply ingrained that I seriously do not think that is an issue.

ACTING CHAIR—Thank you very much for spending so much time with the committee.

Proceedings suspended from 12.59 p.m. to 1.35 p.m.

WILLIAMS, Mr Murray Evan, Executive Director, Georgeson Shareholder Communications Australia Pty Ltd

ACTING CHAIR—Welcome. The committee prefers all evidence to be given in public, but should you at any stage wish to give any or part of your evidence in private you may ask to do so and the committee will consider your request. The committee has before it a written submission from Georgeson Shareholder Communications Australia—submission No. 12. Are there any alterations or additions you would like to make to the submission at this point?

Mr Williams—Not to the submission, only for the record. When the submission was made in November last year, Georgeson Shareholder was a US-owned company. In December last year, it became a wholly owned subsidiary of Computershare Ltd, an Australian listed company.

ACTING CHAIR—I now invite you to make a brief opening statement, then we will proceed to questions.

Mr Williams—Georgeson Shareholder is a company whose lifeblood is dependent upon communication with shareholders. We communicate with approximately 100 million shareholders annually, primarily in the United States, North America, UK, Europe, Australia and New Zealand. In Australia, Georgeson Shareholder has been primarily focused on the proxy voting process, in particular the motivation, if you like, of shareholders to vote, particularly retail shareholders. We also have a lot of involvement in communicating with institutions. Looking internationally, we have noticed over the years some dramatic changes in voting patterns amongst shareholders, primarily in the English-speaking countries where there is a broad similarity of corporate rules and regulations. What we have seen is the emergence of the small retail shareholder as a voice wanting to be heard and not wanting to simply be a holder that does not have a voice. So there has been a growth, shall we say, in corporate democracy that is occurring internationally.

This has come to Australia in the last couple of years where we have seen the corporate governance debate vigorously being carried out. Of course, we have current examples, even right now, of situations where there are large numbers of individual shareholders, owners of a company, who in many cases have felt that they have been disenfranchised because there are a smaller number of individual shareholders who own institutions that hold the majority of shares. We believe that, under the provisions that the committee is currently investigating, there is an opening to permit the authentication of proxy voting other than by writing and the means therefore to enable small retail shareholders to have a direct voice in a very convenient way. We believe that it will promote corporate governance issues. We believe that it will promote corporate democracy. It will most certainly, we believe from our own experience, result in more participation by retail shareholders in issues affecting companies where a vote is required.

ACTING CHAIR—I note in your submission that you speak about the US experience. Would you be able to outline to the committee some of the benefits that you have just listed in your opening statement and the way in which you see them playing out at a practical level in the United States.

Mr Williams—Telephone voting has been growing since it was introduced in the mid-nineties. Primarily, it was introduced to ensure that sufficient quantities of retail investors in mutual funds were able to cast a vote, because under US laws for mutual funds there is a quorum requirement that 50 per cent of holders must vote. Mutual funds do not necessarily vote every year. However, the growing rise of shareholder democracies has put pressure on the funds to come up with a solution. What we have seen is a rapid change in voting, where a growing number of investors are voting by telephone. They are doing it in two ways. They are either calling a toll-free number to deliver their vote or being contacted by the issuer—by the company or, on occasions, by people such as us—and asked if they wish to vote. They are then taken through the voting process.

The major thing we have seen, from an issuer's point of view, is that a company is able to collect proxy votes quickly, efficiently and accurately. If there is any requirement by a shareholder to change their vote this change is effected very quickly, and there are audit trails all the way through from the collecting of the vote to the final, audited result. From the shareholders' point of view, it has been all about two things: convenience and information. It is convenient in that a telephone number can be called, or they may receive a call. In addition to casting a vote, they have the opportunity to ask questions or to quiz the representative of the company about the motions that are being put forward.

ACTING CHAIR—Is there any possibility that arranging for electronic proxy voting could in some way lead to a reduction in transparency or are you confident that the systems will ensure there is no undue influence? Do you think there is any scope for potential conflict there or has that not been the experience internationally?

Mr Williams—That has not been the experience internationally for this reason: each individual call out of the system has to be recorded. There are a set number of steps, which begin with the correct identification of the shareholder. That is obviously done by identifying them through their name, their address, their holding in that company and, importantly, their shareholder identification number, which is equivalent to a bank PIN. Once that is established, the votes are then given and recorded. The system produces a written authentication on paper, which is mailed to the shareholder for their own record. The electronic records are transferred directly to the tabulator, which may be the company itself—us, in the case of Georgeson—or a share registry company, such as Computershare. The way that we record and index is identical to that laid down under the Corporations Law. In fact, the use of that law is a bit of a bonus, because this was not anticipated when the laws requiring mandatory recording for takeovers were brought in. So this is actually a bit of a bonus for us in that regard. We have complete transparency, in that each individual voting transaction can be tracked and recorded. Also, in the same way, that vote can be changed if the shareholder sees fit, then tracked and recorded.

ACTING CHAIR—Are there examples internationally of where there have been disputes? If so, how do the dispute resolution procedures operate?

Mr Williams—There have been issues of dispute—I will come back to them—which related to how the individual believed that they voted their account. The ramifications of that have been zero. By the way, other companies that perform this service have their own various ways of doing it but Georgeson has voice recording. If you are conducting a stockbroking or banking transaction over the phone the recording is the basic evidence of how that person voted. At the

beginning of each conversation it is pointed out—this is under our privacy laws in any event—that the conversation and the voting will be recorded. It does not really get beyond that. There have been no auditing issues in terms of matching back the verbal or telephone votes with the share register.

I am not aware of any problems other than occasionally when an individual thought that they voted yes and asked for it to be checked and indeed they voted no. Most people, if they are voting on the paper system as they do today, will put the ticks or crosses in the boxes. Once it has gone, it has gone. The same thing will happen: 'Did I vote that way? The result that was announced is not the result that I wanted. I was sure that was not going to happen.' They can check the paper vote. There would be one in 100,000 shareholders who might question how they voted. That is an anecdotal number.

Senator CONROY—You mentioned the mandatory recording. How does that impact on your cost structure? What have been the costs of complying with it?

Mr Williams—The costs were very high. I think we invested about $200,000 to be able to comply. It was not the digital voice recording that was the problem—you can buy voice recorders effectively off the shelf. The difficulty was in the indexing and retrieval.

Senator CONROY—The storage must be a huge cost.

Mr Williams—Yes. The storage is an ongoing but fixed cost. We have a contract with a secure organisation who picks up the tapes and keeps them for 12 months. But the IT side of it was a bit of a challenge. Having said that, it has been an absolute boon to us. I must say that we offer it to all our clients, not just in the scenario of a bid, where it is mandatory, but even when we are talking to shareholders in rights issues or information regarding AGMs and we suggest that all calls should be recorded. Indeed, for the most part that has been taken up. There have been occasions when there has been a dispute between a company and the shareholder where the recording has shown what the situation was. It has been extremely useful.

Senator CONROY—Were you contracted during the Coles Myer dispute?

Mr Williams—Yes, we were.

Senator CONROY—I will not ask you any questions on that.

Senator WONG—Are there any mechanisms that could be used for the purposes of security other than recording?

Mr Williams—Do you mean any purposes other than—

Senator WONG—No. Are there any other mechanisms you could use to ensure the security of the vote—that is, that the shareholder is the person who is issuing the instructions?

Mr Williams—The basic things that we would rely on—in a voting situation we would have a share register which would contain the HIN or SRN, depending on how they held their shares—would be their full name, address and details and number of shares. There could be an additional

line of security put in. Ordinarily if a shareholder were calling we would ask them to identify themselves, their holding address et cetera, and ask for that number and check it off against the file. We would ask, 'How many shares do you have?' If there were any differentiation, it could be queried. There could be another line of security put in. When the documentation regarding the proxy vote goes out, a separate code number could very easily be applied.

Senator WONG—Like a telecode.

Mr Williams—Yes. You cannot help it if the paper has got into the hands of someone who is mischievous. Given that it is a proxy vote, it is not like handling bank transfers or that kind of thing. The integrity is very important, but this is not a situation where there could be any overt fraud or interference with the outcome of a vote. If there were telephone voting, you would find that the institutions who are dealing with hundreds of millions of shares will usually continue to rely on paper voting. If it is custodial, which many of them are, they have to comply with certain procedures all the way down the custodian pipeline back to whoever the beneficial owner is. It is unlikely that you would find a problem in institutional voting. In retail, which is what televoting is all about, the chance for mischief is extraordinarily low.

Senator WONG—Theoretically, would an additional line of security in the procedure you have identified impose a significant cost?

Mr Williams—No, it would impose no cost whatsoever. It would be a line in a field which would be used to imprint the shareholder's name, holding or other details. There would be no additional cost.

Senator WONG—It could then be used to authenticate the instructions.

Mr Williams—Correct. It would be a one-off code.

Senator WONG—For the purposes of that ballot.

Mr Williams—For that ballot, yes.

ACTING CHAIR—Being devil's advocate for a moment, do you think that a greater degree of shareholder activism, which would be the logical result in the number of proxy votes that you could reasonably say, leads to a better outcome? Do you think there are a number of non-institutional shareholders that perhaps are not fully informed about market operations and considerations and, by having a greater sense of shareholder activism, you in fact cause people to make decisions or allow for people who have not fully thought through the consequences of decisions to have an influence?

Mr Williams—In our experience over the last five years or so, there is no doubt that the activists who are out there and who seek media attention have had an influence on small shareholders. It is also true that dissident shareholders who are high profile—we can take a couple of known examples: Solomon Lew and Mrs Cathy Walters—attract a lot of attention, and they attract that attention from small shareholders. We did some research into this. I noticed I put the figure of 60 per cent in the submission. That is not right. In the group we surveyed—we surveyed about 4,000 shareholders on a national basis during several proxy solicitation

campaigns to ask the question: where are you getting most of your information from regarding this meeting?—82 per cent said the daily newspaper.

If someone is attracting publicity about a company that a small shareholder has an interest in, then they are going to follow it. If the profile of the issue gets high enough, then you will see an increase in voting. Again, it comes down to another phenomenon with Australians: whenever there is a vote that is against an issue—that is, where shareholders do not want something to occur or where they want to go against the will of the board—those shareholders have traditionally always been in a big minority, but they always vote first and they vote—

Senator CONROY—Vote early, vote often.

Mr Williams—Absolutely.

ACTING CHAIR—Mr Williams, thank you very much for appearing before the committee, especially for coming much earlier than originally scheduled. It is appreciated by the committee.

Mr Williams—Thank you. I appreciate the opportunity.

[1.58 p.m.]

CLARK, Mr Doug, Policy Executive, Securities and Derivatives Industry Association

HORSFIELD, Mr David, Managing Director and Chief Executive Officer, Securities and Derivatives Industry Association

ACTING CHAIR—Welcome. The committee prefers all evidence to be given in public, but should you at any stage wish to give any part of your evidence in private you may ask to do so and the committee will consider your request. The committee has before it a written submission from the Securities and Derivatives Industry Association—submission No. 57. Are there any alterations or additions that you would like to make to the submission at this point?

Mr Horsfield—No.

ACTING CHAIR—I now invite you to make a brief opening statement, and then we will proceed to questions.

Mr Clark—The Securities and Derivatives Industry Association would like to address two aspects of the CLERP 9 draft legislation: firstly, the new provision in relation to conflicts of interest and, secondly, the retail-wholesale definition. In relation to the conflicts of interest provision, we were delighted to see the draft proposal which requires licensees to have adequate processes to manage conflicts of interest. We were disappointed to see it did not make any delineation between the retail and wholesale investors given that, in the stockbroking industry anyway, in the provision of research, institutional clients have very different needs to retail clients. However, we were glad to see the principle based approach in CLERP 9, and we continue to work with ASIC on the promulgation of the underlying policy which will underpin those provisions.

Secondly, we would like to address the problems in the act in relation to wholesale and retail clients and the definitions of those two terms. Our members were disappointed to see that the matter was addressed in the CLERP 9 legislation but that it was decided not to fix it, for want of a better word, to allow a greater time for practical issues to be considered and to allow for the FSR transition to be completed. With the FSR transition period having just completed on 11 March, we would urge the government to now address the definitional problems in the act. We would also submit that there has been ample time to consider the practical difficulties. I will raise a couple of the practical difficulties that our members have suffered, given that we have had the same sorts of difficulties—that is, in relation to prospectuses and disclosure—since I think the CLERP 4 legislation came in in 1998.

Across the Corporations Act there are various scenarios and circumstances in which you need to decide who is a retail investor and who is a wholesale investor. Sadly, it is not just a case of saying who is a retail investor for the purposes of the Corporations Act. There are a number of different definitions of ‘retail investor’. The relevant definition that you must apply depends on the circumstances of the financial service or product being provided. For instance, if you are offering shares without a prospectus, the definition in section 708 applies. If you are offering

units in a managed fund which does not have a product disclosure statement to the same investor then section 761G applies. That is the main one for the purposes of chapter 7. If you are giving advice to an investor on whether or not to deal with securities or managed funds then the definition in section 761G applies as well. If you are dealing in superannuation products, however, the client is always deemed to be a retail investor. We cannot see a justifiable policy reason why there should be these differences and delineations across the different situations covered by the Corporations Act. As a matter of policy, what we are dealing with here is an acknowledgment that certain people are sophisticated and experienced enough to be able to make their own minds up without the need for the additional retail investor protections embodied in the act.

I will run through a few practical examples that our members face every day to demonstrate the difficulties that these divergent definitions are causing. A person who is a wholesale investor under section 708 can be deemed to be wholesale if they can provide an accountant's certificate confirming that they have had gross income for the last two years of at least $250,000 or that they have net assets of $2.5 million. Problems arise with this. It has to be verified by an accountant's certificate that is no longer than six months old, so every six months our members have to roll over a list of these wholesale investors for the purposes of, for instance, participating in share placements.

We cannot see a policy justification for the six-month period. Firstly, you only have to give a tax return once a year. In the hotly debated statement of advice requirements of section 946B that passed through parliament in December, there is a requirement to check the relevant personal circumstances of clients every 12 months at a minimum. We cannot see why this one has to be six months. It causes a lot of logistical and administrative problems. If a person's certificate is seven months old and a hot share placement—for want of a better term—comes along, suddenly they will be frozen out.

There has also been a practical difficulty in relation to joint accounts, where, if a husband and wife want their joint account to participate in a new share placement which does not have a prospectus, there is some uncertainty as to whether the accountant's certificate must cover husband and wife or one party. Most of our members are adopting the view that it should cover both, but it becomes difficult when you are looking at joint accounts and the division of property et cetera.

That is in the prospectus scenario, or the new issue scenario. If we are looking at the different scenario of giving advice with that same definition in relation to the accountant's certificate, the accountant's certificate is still required and the $250,000 income and/or $2.5 million asset test still applies, but there is an additional requirement under that definition that you must also establish that the product or service is not provided for use in connection with a business. There is that additional limb in the chapter 7 definition of 761G, which itself is a difficult concept. It is not further defined in the act what 'in connection with a business' means.

Also, a person is a wholesale investor under section 761G if they acquire the relevant financial product for use in connection with a business that is not a small business where the small business turns not only on the nature of the business—for example, manufacturing or otherwise—but on the number of employees. This is not a wholesale investor, though, for the

purposes of section 708. So, although this investor can be offered managed funds without a product disclosure statement, he or she cannot be offered shares without a prospectus.

Another anomaly between the two main definitions in sections 708 and 761G is that in section 708 there is a provision that, if a licensed dealer is satisfied that the investor is sufficiently sophisticated, then that client can be treated as a wholesale client. They can participate in new share issues without a prospectus, like most placements are these days. However, there is no equivalent provision in section 761G. So, while our members can offer this person shares without a prospectus, they cannot be offered managed funds without a product disclosure statement. They are the main problems in the differing definitions in the two chapters.

There is a common thread, thankfully, in the definitions, and that is the professional investor definition, whereby, if a person controls $10 million in investments, they can be deemed to be a wholesale client. This presents its own practical difficulties: the definition of control—what does that mean? There is a definition of control in the act in section 50AA but it is only in relation to control of companies for the takeover provisions; it does not really bear on this scenario at all.

In common with other definitions, there is a problem in relation to verification—there is no accountant's certificate required for this definition. Good practice would dictate some form of verification or the dealer satisfying themself that the person is professional. If that must be by an accountant's certificate or just by ticking a box on a client form, these are problems that our members are facing.

What we would really like to see is clients being able to be classified once, whether they are retail or wholesale. A recent regulation in relation to the $500,000 minimum product value test has acknowledged this. If you are buying a half a million dollar bond, then you are deemed to be wholesale and that is once and for all. We would like to see a similar provision in relation to the other mainstream tests that our members deal most commonly in, and the most common example is the new issues without a prospectus—the share placements—but also in relation to the advisory requirements: the statements of advice, financial services guide and product disclosure statements, which only retail investors must receive under the act.

Also in relation to the definitions which bear on numbers of employees and the small business test, there are instances where our members have clients who are in cyclical or seasonal businesses, for example fruit-pickers, where the numbers of employees radically change during the course of the year—one week they will be wholesale, the next week they will be retail. That is another example where we would say that they should be able to be classified once and for all. In conclusion, having experienced the prospectus requirements since 1998 since the CLERP 4 amendments came in, on balance the conclusion we would like to see is that the definition for the whole of the act is uniform and it should adopt the section 708 definitions.

ACTING CHAIR—Thank you. That was actually very illuminating, especially with regard to practical examples of the problems that are faced. ASIC released a policy proposal paper on managing conflicts of interest with a specific section concentrating on providers of research reports. Have you seen that?

Mr Clark—Yes, we have.

ACTING CHAIR—Are you satisfied with ASIC's interpretation of what constitutes conflicts of interest in that paper?

Mr Clark—We made a fairly lengthy submission to ASIC on that point. Without getting into the detail of conflicts of interest as a concept, we concentrated, again, more on the practical issue affecting our members which is the specific research proposals, which I think is part 2 of that paper. Our members did not want to get into a great philosophical debate about what is a conflict of interest because the feedback we have is that if people do not know what a conflict of interest is they should not be in business.

Senator CONROY—Your submission mentions an earlier submission made to Treasury where you canvassed a lot of those issues you just discussed. I was wondering if the committee could get a copy of that.

Mr Horsfield—Sure.

Senator CONROY—Thank you. Yesterday ASIC released a guidance paper—a couple of them—relating to product disclosure which gives guidance on how ASIC will administer the new clear, concise and effective disclosure rules. Do you have a view on that? I know it was only yesterday, so you may not have had a chance to look at it.

Mr Horsfield—I have not had a chance to look at it. I do not know whether Doug has had a chance to look at it.

Mr Clark—Just flicking through it, there were no aspects of it which bear upon any of these issues we have discussed today.

Senator CONROY—The CLERP 9 bill inserts a number of changes in relation to continuously quoted securities. Do you support the view of the Securities Institute, who said that the amendments leave the information to be disclosed up to the judgment of the lawyers?

Mr Clark—I have not heard a view expressed by our members—

Mr Horsfield—I haven't either.

Mr Clark—but I know our members would support the greater enforcement of the continuous disclosure law.

Senator CONROY—The CLERP 9 bill also makes changes in relation to exemptions from the disclosure obligations for secondary sales. Can you advise the committee on how these amendments would assist?

Mr Clark—I am not briefed on that.

Mr Horsfield—We would have to take that on notice.

Senator CONROY—That is okay. I know you have quite a specific issue, and it is one that we have spoken about previously. I think everyone would have a lot of sympathy with your views that ask for one consistent rule.

Mr Horsfield—We can get back to you on that.

Senator CONROY—That is fine. That is all the questions I have. You covered off most of the issues I wanted to raise in your opening statement. As I said, we have discussed this before and have some sympathy for your dilemmas.

Senator WONG—As I understand it, you are suggesting that the section 708 provisions be utilised for the purposes of the definition. Do you envisage that there would be any difficulties with that, such as a less protected position for certain people in relation to some transactions? How could that be dealt with?

Mr Clark—I cannot see it. I think that those people who need protection or should get the retail protection of the act would be adequately covered by section 708.

Resolved (on motion by **Senator Wong**, seconded by **Senator Conroy**):

That the committee receives the submission from the Securities and Derivatives Industry Association to Treasury as a supplementary submission.

ACTING CHAIR—Are there any other aspects with respect to the CLERP 9 bill that you have not touched upon in your submission and that you would like to address?

Mr Clark—No.

Senator WONG—They are being very focused. Don't come before the government with too many asks; if you have a short list, you are more likely to get it.

Mr Horsfield—The big problem we had is really with wholesale and retail. That is the No. 1 problem.

ACTING CHAIR—Thank you very much for attending today. The committee appreciates it.

Proceedings suspended from 2.17 p.m. to 3.16 p.m.

HARRINGTON, Mr Anthony Patrick David, Chief Executive Officer, PricewaterhouseCoopers

WARD, Mr Robert, National Managing Partner, PricewaterhouseCoopers

ACTING CHAIR—Welcome. The committee prefers all evidence to be given in public, but should you at any stage wish to give any part of your evidence in private you may ask to do so and the committee will consider your request. The committee has before it written submission No. 27, from PricewaterhouseCoopers. Are there any alterations or additions you would like to make to your submission at this stage?

Mr Harrington—No, there are not.

ACTING CHAIR—I now invite you to make a brief opening statement, and we will then proceed to questions.

Mr Harrington—At PwC, we are embracing the proposed CLERP 9 changes and intend implementing them in both letter and spirit and doing everything in our power to regain the trust in our profession, because we do recognise the important role that audit plays in the capital markets. However, it is not just about auditor independence, so PwC are developing new policies, tools, systems, methodologies for complying with the letter and the spirit of CLERP 9. We have updated our audit procedures globally to ensure we are addressing today's risks and meeting investors' expectations. To that end, recent policy changes have improved guidance and focus in a number of key areas, particularly around dealing with understanding business and industry issues and the effective evaluation of risk as it applies to particular business operations.

We also think that communicating effectively and candidly with audit committees is critical in today's environment, so we have developed a new audit committee framework, which covers four specific topics: auditor approach, our view of the company's level of audit risk and management's control to mitigate key levels of risk, the reliability and transparency of management's financial reporting, and the broad area of corporate governance. Our public company engagement teams are very much focused on the whole area of effective communication with audit committees. At PwC, we are also committed to transparency and accountability, and I think we have reflected that in the last couple of years, in particular, with the establishment of our audit standards oversight board. We think that, given its composition and scope, that is probably a good role model for a co-regulatory framework that could be applied more broadly across the profession.

There has been a lot of comment recently about the need for the profession to recruit the best and brightest, but the issues that the profession faces in this area are probably twofold: firstly, can we continue to attract the right people into the profession and, secondly, is the quality of the education today sufficient to properly train these young people to actually do the difficult tasks that they have before them? I think that, given the events of the last couple of years, one has to be concerned about whether the best and brightest students will continue to join us as they have in the past. The confidence of the profession has been impacted more recently over the last few

years, and there continues to be a negative focus around the profession these days, particularly in the media.

One of the principal concerns that I have is our ability to continue to attract the best and brightest into the future. I do not think that we can necessarily fulfil the mission that we have in performing public company audits effectively unless we do have the best and brightest. To ensure that we restore public confidence, it is important from the profession's point of view that we do have audit professionals in our practice who have both the intellect and the capability of going face to face with those executives that they meet in their day-to-day lives in fulfilling their audit function.

So, in this regard, we believe the proposed 'no more than one' rule, for want of a general description of it, will further diminish our profession's ability to attract the best and brightest—and I am happy to expand on that in questions—and will potentially significantly diminish the pool of talent with financial expertise that is available in the broader business community. I think that, in essence, completes the opening remarks I would like to make. I thank this committee for the leadership it has shown in the area. I think that the legislation that has been developed to date is well focused in the context of being principles based as opposed to rules based. It is a good step forward, and we are very supportive.

ACTING CHAIR—Thank you. We have had evidence from previous witnesses today about the CLERP 9 responses perhaps being overly concerned with the perception of independence rather than actual independence. They went so far as to make reference to the perception that arises in an informed marketplace versus the perception that arises in an uninformed marketplace. Do you have any comments on that?

Mr Ward—I am happy to talk about that. The whole issue of independence is at the centre of the whole debate. It comes to the issue of rules and principles—they are aligned. There is a lot of confusion about whether independence is just established through rules as opposed to a state of mind. If you take state of mind to the extreme left or right—I am not sure which—it is one of dishonesty. You cannot legislate or regulate for honesty. We have seen lots of evidence of that, either in the corporate arena or in others. So how do you create a framework that enables true independence so that a professional can operate in a way that, firstly, is workable and, secondly, has a perception of independence? If there is one thing that has changed in the profession in the last two to three years, it is that issue of perception. As the leader of our audit practice I can say that I have never seen, in my time as a partner in our firm or as the leader of the audit practice, a situation where the genuine nature of an audit partner's independence was ever implicated by other services we provided—never. Their reputations and the reputation of the firm were too important to affect their audit opinion. However, you could possibly understand that, if that ratio of audit fees to non-audit fees were out of genuine balance, the perception might be created that independence might have been impinged; although in reality it was not the case.

Creating an environment where we try to define and over-regulate independence but where it does not in fact add any value creates a negative situation of breaking rules or an environment where technical rules might be broken where there is actually good work being done to enhance the quality of good audit work. This is the fine balance that I think CLERP 9 was looking for. In the final legislation we hope that balance is found so that we do not to go back to a rules environment that impinges upon quality and keeps good people out of the work in both the short

and long term. If you look at the short term, good quality auditing might actually include other services that are natural to accounting and audit firms and that enhance the quality of the audit, but they might actually be defined as 'other services'; so in fact quality is diminished rather than enhanced. So it is about finding that balance. I go back to a point I made earlier: you cannot create rules to keep people honest; professionalism is a very important point.

ACTING CHAIR—When it comes to, for example, audit rotation, cooling-off periods and the provision of non-audit services—you touched on the latter before—is the balance appropriate, as it is struck under CLERP 9?

Mr Ward—Are you talking about people joining, clients et cetera?

ACTING CHAIR—I am talking about rotation and the cooling-off period of two years.

Mr Ward—I think that a rotation period of, say, five years is probably now an accepted thing. This goes to the issue of quality. The larger firms are probably better positioned to comply with that. I would say the smaller firms will find difficulty in complying—and I do not know if that actually advances the profession. I will leave that with the committee to think about; I do not know what the solution is. I then come to the issue of people joining. I think that the restriction on the audit partner or teams probably does enhance things. That goes to our point that the next layer of restriction of other partners joining an organisation of which the firm might be the auditor is a very difficult one and, practically, difficult to implement. It may not add value in the short, the medium or the long term.

Mr Harrington—I think the message has been delivered, in the context of recognising the issue of perceived independence in respect of composition of executive teams and boards. I know there is a debate about two years versus four years in relation to the cooling-off period, but I think the message is already out there loud and clear in the marketplace. Boards are dealing with it in an effective manner today, in a different way to the way they had previously. Whether it is two years or four, the actual behaviour in the selection processes for senior executive positions and boards has changed. I think that is evident in the way people are executing their board selection processes today.

The other issue for us is a challenge and a balance. I think there has been too great an emphasis placed on this. That is not to say that independence and critical thinking are not very important elements of the capability to undertake an audit effectively, but there has to be balance. The balance must ensure that there is a recognition of all the quality efforts that are being put in place and have been in place for many a long year in the way audits are undertaken and that appropriate oversight is also a key element. Hence our step to give some transparency with our audit standards oversight board.

We can put a lot of emphasis on issues of process as to the underlying substance of what we are trying to achieve, sometimes to the extent that we put too much emphasis on issues of practical rules. An example is the one year with no more than one audit partner either on a board or in a senior management position. I can understand, logically, how you can get there, in light of the HIH recommendations, and I do not dispute that. But I do question the impact. I can relate a particular story of one of our candidates who is just about to become a partner. With all these rules now, and the interest that we have in a particular industry and our involvement in that

industry, he said, 'I'm not sure I want to be a partner, because if I become a partner then I lose my ability to go out from the firm.' In this day and age, lifetime careers in professional services firms are not the norm. The challenge is much more significant than it was when Rob and I started. So people look to multiple careers and, in that context, this is impacting the decisions that young professionals are making about their desire to stay in the profession. Being a partner can actually put a restraint on their ability to operate in the marketplace, should they decide to leave. So that is a challenge for us, and I think it is a reason why boards have taken on issues of behavioural change around independence and board selectivity.

Senator CONROY—I want to follow up on your partner problem. What percentage of companies in the top 200 do you audit?

Mr Ward—Approximately 35 to 40 per cent in the top 200.

Senator CONROY—Would any of these restrictions stop them becoming an employee or being on the board of the other 65 per cent of companies, which you do not audit?

Mr Harrington—I think you have to look at it from the perspective of the individual—the young person developing a career. The challenge they face is: if I develop my career in another area of the financial industry, in either the corporate game or the banking arena, then I have access to move my career permanently into the whole market. With the continual change and rotation that does occur with staff on jobs, over time the potential for somebody who does become a partner—this is on an ongoing basis—is challenged because they say, 'Hang on, this firm has a footprint on 30 per cent,' but that is not a constant 30 per cent in respect of the audits that we do, because over time tenders come up and the relationships change. So it is not just a matter of a pure 30 per cent at a static point in time, because the population of the audit firms like ours do change over time. Being a partner and being forever tagged with that in your professional career and the inability to then operate on one of our audits is, I think, difficult—just as a judgment. It is a hurdle.

Senator CONROY—Putting aside the two-year/four-year argument, you are indicating an acceptance of the two years and that there does need to be a cooling-off period. In your view, is there really an independence issue there at all, or is this just something you have to put up with even if it is just the two years?

Mr Ward—Sorry, which part?

Senator CONROY—Regarding genuine independence—are you saying this is the response on the basis of the perception of independence or on the reality of it?

Mr Ward—I think it is a combination of both. It does address the perception issue and I think that is a good thing. Going to the four years—and this the arbitrage on that debate—the law of diminishing returns and the value to the capital markets diminishes dramatically if it is on the basis of perception. On the basis of reality, if you have honest people—and this is dealing with their carrying out their fiduciary responsibility—it is probably not real, but I think the two-year cooling-off period probably does enhance perceptions that it is of value.

I would make a comment, maybe not for CLERP 9 but regarding the committee's understanding of some of the dynamics we are dealing with: there is some confusion in the market between independence and commercial conflict. At the moment we are talking about the conduct of external audits, but I think we are even finding, where people leave our firm and join non-audit clients, that the media might be determining that there is some impairment of independence in respect of those arrangements of that partner and the firm, which in fact is untrue. So it is about the extension and confusion of the word 'independence', which is a very technical term and has been overused to the detriment of the system, the profession and the markets.

Mr Harrington—In a practical context, if you look at the size of our market—and it is not a huge market—you can foresee scenarios where young partners of the firm are attracted to join a firm that happens to be a non-audit client at a particular point in time or someone we are not involved in at that point in time. You could see a scenario where two people find themselves either in a board situation and maybe in the CFO role and then suddenly that particular organisation decides to review their audit arrangements and, because there happen to be two retired partners in roles pursuant to the no-more-than-one rule, we are out of the game and cannot participate in the tender process. I do agree with the two-year cooling-off period. I think that makes a lot of sense. But, with that in place and with the behavioural change that that creates, having a situation where in perpetuity you say no more than one, it causes problems.

Senator CONROY—I have to confess that I struggle with the argument that Mr Ward put forward about reputational risk. Reputational risk existed before HIH and it exists today, but Andersen had a specific policy of placing partners onto boards around the world, not just in Australia. They were one of the big five, so it is not as though they were a mickey mouse company. They were quite prepared to chance their arm. Ultimately, it now looks like there was a systemic problem. There is grief, and they are gone. They argued: 'Just trust us. We would never do something systemic that would cause a problem like that. The proof of the pudding is in the eating.' These were your peers internationally and locally. Yet non-Andersen survivors come forward and say, 'Just trust us. We would never risk that.' But if Andersen people were sitting here a week before HIH fell over, they would have said the same thing: 'Trust us. We would never do something that would potentially jeopardise our reputation. It is just too much of a risk.' But they were engaged in the systematic placement of partners all around the world onto the boards of companies that they were auditing.

Mr Harrington—I will attempt to answer that. I understand the core of your concern. CLERP 9 enables substantial reform and, to various extents, is being mirrored around the world. We can zero in on the specific detail of one particular factor, but it is the combination of the reform agenda that has the impact and shifts behaviour. All of the stock exchange guidelines and principles that are now in place are shifting behaviour. The recognition by board chairmen and recent press in the last few days would say that there is a greater awareness and significance placed on the composition of boards, both in the expertise that they bring to the table and the conflicts that they have had. In a whole variety of real-life instances, we have now seen examples where changes are happening on boards. I think we need to take stock and look at exactly how the business community adapts to the changed regulatory environment that CLERP 9 enables. We can always come back and revisit the need for a bit of additional adjustment if there is a need for more prescriptive rules. There is a balance needed. That is my point.

Senator CONROY—I guess—and this is a little close to home, and I know that it is difficult to talk about something that is current—

Mr Harrington—I am more than happy to.

Senator CONROY—particularly if, Mr Harrington, you disqualified yourself from conducting an important review on the basis of a conflict of interest.

Mr Harrington—As I am sure you know, Stephen, you should never read and take as fact everything that appears in the press.

Senator CONROY—Perhaps this is your chance to correct the record, with the protection of parliamentary privilege. KPMG would make the same argument. They allowed one of their partners to go and work for one of their clients, and ultimately the reputation rests with KPMG, as they are copping a beating now. Their reputation has now been diminished, I would argue. Ultimately I think they will survive and grow and prosper, but the NAB-Lewis-KPMG connection is again an argument to say that 'Trust us' does not quite always work. The two years would probably have disqualified a lot of this.

Mr Harrington—It would deal with that, I think.

Mr Ward—I think it deals with the specific. Before we leave that, I would like to address one of those points on the reputation issue. Often out of adversity come some good things. In my professional career and as the President of the Institute of Chartered Accountants, reputation has been everything. We have always held that out. But I do not want to speak for the behaviour of Arthur Andersen that led to where it led. There is a lot of learning coming out of that, and the serious learning is that, when they had that problem—in the US in particular, when the indictment was issued—their clients left them in droves. It brought home realistically how important reputation is. Trust was lost. That trust has been tested in this new world now, with communication and whatever it might be—with greater diversity of shareholding affecting the whole fabric of the community, not just the institutions that might have been affected 20 or 30 years ago. More people are affected, and the community is intolerant. It is intolerant of that behaviour, whether it be in our profession, your profession or many others—boards et cetera. I think there is a seriously heightened awareness and intolerance. That is a very important point. I think that is tested. In fact I have said at boards that we have always stood behind our name and actions, and our record stands for itself. We could be challenged on any part of it, and we would be happy to be so. We have to every day. Others can stand on their own record.

Senator CONROY—I am interested in how—and this is a little unfair, but we have the protection of parliamentary privilege so I am trying not to be too unfair—you guys would have felt about tendering for a job with a former partner of the existing audit firm conducting the audit. Is there a perception of independence problem there?

Mr Ward—Can you ask the question again, please?

Senator CONROY—With NAB, Chris Lewis was in charge of the tender process for the audit. You guys had the losing bid. Was there no perception of independence problem there, or no reality of independence problem there?

Mr Harrington—As I understood the scenario, the issue was that the audit committee was in charge of the process, and collectively they came to a conclusion—

Senator CONROY—Mrs Walter had a casting vote.

Mr Harrington—Factually I do not know that to be correct or otherwise. I just do not know. There is an enormous amount of speculation, including the speculation that you mentioned previously in respect of my role in the NAB assignment. It is factually incorrect. We were approached—I was approached—by the National Australia Bank to assist in undertaking some work to (1) identify where the errors had occurred within the bank, and (2) report on those. We put together a team that was a global team with joint engagement partners, one being a local partner and one being a partner out of the UK with global banking experience. I have got every confidence about the procedures that we had in place, the investigation and the way we undertook it. Wrapped around that was a very extensive probity process, which I know you are very familiar with. It was a very extensive probity process that we enjoyed immensely. In addition to that we had an APRA report and an investigation that basically agreed in every respect with our conclusions.

Nobody, from my understanding of any of the press, has questioned the APRA report or the content of our report. So I am more than confident as to the role we played in that piece of work. I think what it does demonstrate is that there is a quite perverse focus in this area of independence, where there is confusion about issues of independence and conflict of interest. Here is a scenario where we are not the auditor, yet, just because we derived an amount of fees in respect of other work, there are comments being made that question our independence. If that is fundamentally correct then there is not an audit in the land that has been done that does not suffer that same concern. So there needs to be balance brought into this debate. At the moment it is not terribly balanced.

Senator CONROY—Personally, I have really enjoyed some NAB board members' recent discovery of the corporate governance principles that they now espouse. We can always welcome a conversion on the road to Damascus. But I will move on, because I appreciate that this is a very sensitive area. I appreciate your frankness in your answers so far. An article on the front of today's *Australian Financial Review* is headed 'Auditors told to dob in executives'. I want to talk about the ASIC guidance papers which were released yesterday. Have you had a chance to have a look at them or have you been stuck in meetings all day on them?

Mr Harrington—No, I have not been stuck in meetings all day. I have briefly looked at them, and I think they still need work. There is a period through to about mid-May for comment.

Senator CONROY—They are drafts, yes.

Mr Harrington—They are drafts, and they do need some work. I am sure Rob, given his audit experience, would love to comment. My view is that the audit role is a critical role. For it to be performed effectively, there needs to be open and transparent access to the company's records and a free and frank dialogue. So, in the crafting of the ASIC guidance notes in this area, I think there will be a need for a quite important focus on how that is done, to ensure that we do not create an environment where the auditor, in their role, is seen as just an extended arm of ASIC performing ASIC's function.

Senator CONROY—Professor Ramsay, who is quoted in the article today, says that the provision is designed to get audit firms more proactive and to put in place systems to detect breaches of the Corporations Act. He goes on to say:

... it might be that the things that occurred at the National Australia Bank might have been picked up earlier.

"It will create a culture of proactive investigation ... it turns auditors more into watchdogs ...

He then said that the CLERP 9 proposals now have 'some bite'. Would you agree with that?

Mr Ward—Which aspect of that? With Professor Ramsay or the proposal?

Senator CONROY—Professor Ramsay is commenting on the proposals. You are saying they need a little finessing; he is saying he likes them the way they are.

Mr Ward—The general principle of Professor Ramsay—that is, anything that helps auditors do their work—I would probably agree with. One of the things that has been lost, though, in the whole debate since HIH, Enron in the US and others is that there is excellent work going on all day, every day that is not in the media. Auditors are doing their jobs, causing changes to accounts and getting the right results. That happens every day, and I see evidence of that in my role at the firm all of the time. There have been a couple of spectacular failures, but I do not think it is necessarily a fair representation that changes have been the cause. In fact, when you need to use the act of last resort, you have nearly failed, in that the company is nearly beyond help. The company is in trouble because it has not taken responsibility for itself. We have had a couple of circumstances in the last two years which have attracted attention, where we have stood our ground when clients of ours have decided to take another view. That good work does not appear to attract the interest of commentators, although it is very public. That calibre of work is happening all of the time. So, while section 311, and variations of it, might be helpful, it is only ever used in the last resort, as opposed to all the layers of doing good work beforehand.

Senator CONROY—I am sure that the other members of the committee sympathise with being unable to get the media to report positive things and only ever focusing on the negatives.

Mr Ward—I am sure you do—you live with it all of the time. The issue, though, is that lots of good work is done that would never attract the attention of the media and we would never expect them to report it.

Mr Harrington—The other specific point here is that, in relation to section 311, the judgment needs to be left. Auditing is an art; it is not a science. There is an enormous amount of judgment involved because of the complexity of the issues that need to be addressed and dealt with. If the practice note decides to define too specifically and eliminate judgment in one area as to what is considered significant, I think it will be to the detriment of the ability of the auditor to perform their role effectively. They need to have an unfettered ability to exercise their judgment effectively.

Senator CONROY—Do you support the new CLERP 9 obligation which requires an auditor to report to ASIC circumstances where a person tries to unduly influence, coerce, manipulate or mislead a person involved in an audit?

Mr Harrington—Yes.

Senator CONROY—What about the requirement to report to ASIC circumstances which amount to an attempt to interfere with the proper conduct of the audit?

Mr Harrington—I think the challenge with the reporting responsibility to ASIC—and this goes back to my opening points on this—is that you need to consider these effectively. There is a chain of command, for want of a better term, and there may well be statements made in the performance of an audit that need to be properly dealt with through these channels. That means potentially dealing with the chief executive and, if there is an issue, the chief executive raising it with the board through the audit committee. I think there is a need to deal with that in a proper manner and ensure that the protocols around it are not too prescriptive, because you are going to damage the ability of the auditor to get about and do that audit. Everybody agrees with the intent, but I would just proffer words of caution. I am sure that, as we go through the dialogue with ASIC about the final crafting of the practice note, we will do it in a sensible manner that does not in fact hinder the ability of the auditor to have full and frank dialogue that may create some healthy tension in the relationship, which I think is appropriate.

Senator CONROY—I just want to talk about the Financial Reporting Council. Do you support the proposal in the CLERP 9 bill for the FRC to oversee auditor independence requirements in Australia?

Mr Ward—I would say yes, but I think there is some water to go under the bridge on that and with bringing the auditing standards into law and defining the role of the FRC and all of the various components of that. The profession codification on independence we think is frankly excellent. If that statement of independence is what is used to determine whether we have complied then that is fine. If it creates a whole range of other rules that overdetermine the state of mind then I would say no.

ACTING CHAIR—Mr Ward, if you would like to take some questions on notice and come back to the committee, I am sure the committee would not mind.

Mr Harrington—I think the issue is well demonstrated by our creation of an audit standards oversight board. As an organisation, we recognise that there is benefit to be gained from having appropriate oversight and review of the procedures that we have in place to ensure quality and to ensure continuous improvement around what we are doing in the context of delivering an audit. The work we do in delivering an effective audit in itself is not static. As business changes and the environment in which we operate becomes more complex, we need to continually enhance the approach that we apply and the methodologies that we apply to conduct an audit effectively. Audits are complex pieces of work to achieve a particular outcome. As an organisation, we invest substantially to ensure that the quality of our people—the knowledge that our people have and the experience that they gain—is fit for the purpose of achieving the right outcome. From our perspective having transparency around the way we go about doing that is healthy.

The FRC's role in oversighting that—again, as Mr Ward said, provided it is not done in a rules based sense and it goes to the core of the issue—should be supportive of the profession. We talk about the concept that there is a range of players involved in a continuum that ensures the sustainability of the capital markets—the operating managers, the boards, the investment

analysts, the auditors and, to a fair extent, the regulators and the government that set frameworks. All of them need to operate effectively, but all of us need to operate in a collaborative manner.

There is a debate in the profession about the FRC's role. We see a need for the FRC to play a supportive role in enabling the profession to continuously improve as opposed to an environment where ASIC, for example, might potentially take more of a policeman approach. The two are quite different. I think the supportive approach towards the profession to provide an environment whereby the profession continues to improve its quality is a positive approach. An approach that is more about picking through the detail and trying to identify where it could have been done better is not an appropriate approach. It creates a combative environment as opposed to a supportive environment.

Senator CONROY—Some of your comments on the accounting standards may also apply to the proposal for the FRC to oversee audit standard setting arrangements. You made some general comments that possibly covered the audit as well.

Mr Ward—I think there is some way to go on that. If you look at accounting standards, which I think have been relatively successful with the support of law, they can define how to account—it is more factually based et cetera. I think time will tell that it will be more difficult than we might otherwise have anticipated to codify auditing standards with the support of law. I say that because good auditing is based on certain principles, dare I say it, of a qualified and independent state of mind—all of those things—and all the various procedures. Good auditing, though, is auditing not what is there but what is not there. I do not know how law can say, 'Audit what is not apparent,' so it becomes more of an art than a science as opposed to how to account for this particular set of circumstances. In the next layer of that there is a risk, and certainly over the next two years as that is worked through we will probably end up with something that might be better, but I think it is going to be more difficult than is anticipated.

There is also a risk for the firms and the profession. If a procedure is legislated—that is, I need to sign an engagement letter—do you want to have people who have effectively broken the law around a procedure in an audit, as opposed to finding that the audit opinion was appropriate? As we go through the next two years those challenges will be there. I think it could be harder than we expect.

Senator CONROY—I want to talk about the auditing standards issue.

Mr Ward—And that point went to the issue of auditing standards.

Senator CONROY—In your view, should the auditing standards receive legal backing?

Mr Ward—The short answer is that I agree with the intent; I just do not know whether it is practical.

Senator CONROY—What is the benefit of Australia adopting international auditing standards?

Mr Ward—If you look at accounting standards and the whole discussion on IFRS you see that it is a further sophistication and development of the audit profession's role globally within capital markets and opining on accounting standards. Is it a progression? Yes, it is. Is it developing? Yes, successfully. Is the quality exactly where we want it to be? Not yet, but it is getting there. Does it enhance flow between capital markets in a global world? Yes, I think it does, and it is consistent with international financial reporting standards. I think it is a natural extension.

Senator CONROY—You made a point about the quality of standards. You said it was not there yet, or something along those lines. In your view, are all existing international auditing standards of equal or higher quality than existing Australian standards?

Mr Ward—I have not carried out a paragraph-by-paragraph analysis to answer your question. Is it being developed in a way that is consistent with the quality we either want or will get? Yes. Is it there now? No. But that should not decry the good work that is being done.

Senator CONROY—We had a debate in 1998 about international accounting standards and there was the very strong argument that the International Accounting Standards Board is a bit of a joke: it is not robust, it is not resourced and it does not have credible quality. Today you would not argue that. You have Tweedie, a well-resourced board, the trustees and robust debate. You could not say that the international auditing standards and the board are of the quality or robustness of the IASB. If I am being unfair, please say so.

Mr Ward—Compared to, say, five years ago the auditing standards have come a long way.

Senator CONROY—I accept that they are now of a much higher standard than they were a few years ago.

Mr Ward—A few years ago, as President of the Institute of Chartered Accountants, I supported the harmonisation of international and Australian accounting standards at that time. I think it is proving and will be proven to be the right thing to have done. It is exactly the same position with auditing standards now, and in the next three to five years it will be even better. In fact it is a natural extension of accounting standards. It would be crazy to think that international accounting standards had harmonised and globalised and not to have done the same thing with auditing standards, not just for the Australian market but also for other markets. Australia's penetration in investing in global markets is relatively high, and to protect the Australian investor that is equally important.

Senator CONROY—I think you are part of a joint submission under the umbrella of the ICA and CPA which argued that if legal backing does occur then the auditing standards should not be disallowable instruments. Could you advise the committee why they should not be? I will try not to take it personally.

Mr Harrington—I think it surrounds the issue of a standard in its entirety. I think that is the main concern. It just goes back to the core issue and the point that Mr Ward was making earlier: auditing standards being based on judgment. To apply them in a prescriptive way such that they are subject to legal interpretation in their application, which ultimately will be the case in the context of their having the force of law, is quite a different application from what would be the

case for accounting standards. Accounting standards are to a degree prescriptive in relation to particular applications of accounting rules. Auditing standards need a level of judgment and expertise to be applied, and it is quite different.

Senator CONROY—I appreciate that point, but the point I was making was that at the moment they are going to be with the force of law. This is about the method by which they pass through parliament, if they are going to be, not the difficulty of interpreting them. I accept that is a very valid point: with the way they are worded at the moment there is a lot of uncertainty and concern about how a legal interpretation will work. But this is the form by which they should pass through parliament. Rather than parliament being just a rubber stamp signer of a blank cheque, the role of parliament is to debate the law. So to argue that the standards should be passed through parliament but not be subject to disallowance or being voted against is a little tough on a parliamentary committee, because we take ourselves a little more seriously than that—most people say we take ourselves too seriously! You made the point that that is an argument not to put them through parliament, and that may be a valid point, but at the moment the intent is to put them through parliament. My question is: why should they not be able to be voted upon if they are going to go through parliament?

Mr Harrington—I suppose the rationale is that the preference is that it is not appropriate, I think, for the auditing standards to basically be codified into law. To the extent of the procedural aspect of how that is dealt with, I am happy to take that question on notice.

Senator CONROY—So your basic position is that they should not actually be codified—it should not actually be going through the parliament—rather than you not really caring how it goes through the parliament? You just do not think that should be.

Mr Harrington—Correct.

Senator CONROY—Mr Ward?

Mr Ward—I agree with that and I will give an example. If the regulator were determining the appropriateness of an opinion on a set of financial statements, is that audit opinion appropriate? In the end they will determine it based on the application of judgment to the facts as opposed to the process of the auditor arriving at that judgment. So by going back to layers of process—

Senator CONROY—Lawyers: they just like ticking boxes!

Mr Ward—They love us.

ACTING CHAIR (Senator Wong)—That is a bit of a straw man. Can I jump in there?

Senator CONROY—Go for it! The acting chair is a lawyer, I have to warn you.

ACTING CHAIR—Ex-lawyer. I appreciate the argument about codification and the difficulty in translating a standard which is inherently, at least in part, judgment based into a codified scheme. I appreciate that. It does not seem to me that it stacks up—and I appreciate the concession you have made—in relation to it being given force of law and whether it is a disallowable instrument or otherwise. Really your argument does not go to that issue. The

second point is that I can conceive of quite a number of areas of law where matters of discretion and judgment are given statutory force, and the issue would then be: how does one police it? Obviously then one looks to expert witnesses and so forth, and there is a different way in which one might look at enforcing such a standard as opposed to a process based standard. But I do not know that it is inherently impossible to give it legal backing.

Mr Ward—No; in fact, you are better placed to challenge the process than I am in terms of how you get to that. I just know—I guess based on my experience where I might have taken an interest in audit failure in the profession generally—that the failure or the judgment on the appropriateness of the opinion probably did not need the codification in the law. There could have been just very bad judgment. It could have been dishonesty by whomever. So I am not necessarily sure—if I am going to a principle now—whether the codification of auditing standards in the law is necessarily going to get the desired outcome.

ACTING CHAIR—Or giving them legal force, which is a different issue to codification.

Mr Ward—Yes, it is. I would rather regulators regulate.

ACTING CHAIR—Perhaps the argument is that it would ensure that people are very clear about turning their minds to those standards.

Mr Ward—That might be it, if there is an assumption that people are not now willingly doing that where there has been an appropriate audit opinion that there has been dishonesty or negligence, as opposed to a willingness to have knowledge.

Mr Harrington—This point goes to one of the comments Mr Ward made earlier. The reforms that are proposed are broad, and this is one of the pieces of reform that is proposed, but the reality is that there are thousands of audits conducted each day that are not a problem. If there is a fundamental concern here that there is wholesale lack of application of appropriate auditing standards, I can give the committee confidence that that is not the case.

ACTING CHAIR—But one could turn your argument around and say that, if the profession are complying with the standards currently, then they ought not to have anything to fear from giving them legal backing.

Mr Ward—I do not think our firm—and Mr Harrington can speak for our collective view on this—is coming from a position of defensiveness. We are trying to get the best outcome. If I can say how I think we will get the best outcome, it is by giving the regulator the resources and the power to enforce, fast and hard, when something goes seriously wrong. That is a better outcome than trying to create rules that actually will not be for (a) competent people and (b) dishonest people.

Senator CONROY—The combined joint submission talks about the role of the FRP and says that it should be expanded to include a role for adjudication of issues prior to the publication of financial statements. In contrast, Keith Alfredson, who I am sure is well known to both of you, has made a submission stating:

Such a process would ... undermine the independence and professionalism of auditors and could become a process for allowing auditors not to have to make the "tough" decisions.

Why shouldn't auditors have to take a stand on interpretation of the accounting standards? Isn't that their job?

Mr Ward—I think that is their job. In fact, I think, that using the FRP—or, as it was at one stage potentially going to be referred to, the UIG—is shifting the problem. If the auditor is the registered company auditor, the firm of which that person is a partner is charged with the responsibility to comply with the law and with forming an opinion as to the compliance of the accounting standards. They can seek counsel internally. In fact, I have seen it happen in practice. This, again, is where it works. Where we have found we have a very difficult issue with a client, we have spoken to the regulator on a no-names basis to get action and to get the result that is appropriate in the interests of the shareholders. To set up another process of a panel opinion that waters this down and uses its views against the auditor would, I think, not be in the long-term interest.

Senator CONROY—I want to talk about auditing your own work. Is there work that you should not audit? Should you audit your own valuation services, for instance?

Mr Harrington—There is no doubt that there are quite comprehensive guidelines from an auditor independence point of view in F1 and in the international standards. We have routinely followed and continue to quite explicitly follow those. There are a series of specific guidelines, including for bookkeeping. There are a range of services that we clearly do not do in the context of our audit clients, and we will continue to religiously look at the standards that are set in a sensible and balanced way and apply those. I am confident, in the context of international auditing standards, that a fair degree of rigour is brought to setting these guidelines.

I think there is reasonable global recognition that there are clearly some services such as bookkeeping and areas such as auditing your own work where it is inappropriate in the context of an audit that you should be doing that sort of work. We religiously follow those procedures. That said, there is continual debate about creating an environment where no other work is done by an auditor in the context of working with a particular client. I think that is a fundamentally flawed approach. There is a range of other services that a firm like ours can and should quite legitimately be able to provide—particularly, for example, in the tax area. I think it would be in the government's interest for tax to be a substantial item in a profit and loss account relative to other expense items. Hence, it does have a material impact. The auditor's thorough knowledge—and I think this committee would take on board the increased complexities that now exist in the tax arena—and the auditor's thorough understanding of the tax affairs of an organisation are an important part of doing an audit. There are services that are not within the statutory definition of an audit but are clearly very important.

Senator CONROY—You would be aware that KPMG now have a problem in the US. Fourteen states are taking out a case against their tax advice to WorldCom, or NCI as it is now known. They want tax of $150-odd million, I think. They are basically saying, 'How could they audit their own tax work when they set up these tax scams to avoid tax?' I appreciate that it is just a claim at this stage. That must be a tricky one—being able to audit your own tax advice.

Mr Harrington—I think that, in all of these areas, you have to follow a principle as opposed to a specific prescriptive rule. We have audit committees now very heavily engaged in the role that the auditor plays, both in setting the scope of the work and reviewing other services. I think the role of the audit committee in that context is the appropriate place for judgment to be applied as to what other services should or should not be performed in the context of an audit. If we start to get too prescriptive then we start to set a range of rules that I think will ultimately undermine the capability of an auditor. I come from a tax background and I know the complexities of the tax field. If you take just one end of the spectrum such as the compliance piece of satisfying obligations under the tax act, the fact that the audit firm understands the detail of the issues is helpful for you in the conduct of an audit. Otherwise we can layer on a lot of process and cost.

Senator CONROY—But, in terms of the KPMG problem in the US about auditing your own tax advice on schemes which, to be kind, one could say are designed to minimise tax and are possibly pushing the envelope, do you not see an inherent problem? I appreciate, Mr Harrington, that you are actually from the tax side so this is something that you can speak on expertly. But how do you avoid the perception? You talked about perception versus reality earlier. How do you avoid the perception that you are actually auditing your own work there and ultimately that puts you in a position of serious potential conflict of interest?

Mr Harrington—I think there is a fundamental principle of not auditing your own work. I do not know the specific facts of the case you refer to, but the principle that is applied and which audit committees now clearly have an obligation to oversight is that, in the range of tax services, you should not move into a zone where there is a concern about your auditing your own work. I do not think we are in disagreement there.

Senator CONROY—It is hard for us to draw a parliamentary line. There must be some guidance. Does F1 cover this area? F1 does not say 'no tax'. Where do you go for guidance? You say it is the audit committee's job. We discovered recently that some audit committees do not have a clue what they are doing—some even now claim that ignorance is actually a defence on an audit committee. I am not a fan of that view.

Mr Ward—F1 does go to the principle, frankly, of state of mind and when the auditor has not been placed into a position of expressing an independent opinion. You have to take it circumstance by circumstance. Can I give you a real-life client example. A client had decided that it was inappropriate for our firm to carry out due diligence—that is, a review of an acquisition they were making. They sought another firm to do that work because they did not want us to audit our own work.

Senator CONROY—Clearly it was not the NAB.

Mr Ward—No, this was an audit client. We have never been the auditors of the National Australia Bank.

Senator CONROY—No, no-one else has in 127 years, or something ridiculous like that.

Mr Ward—In this particular case, we had to reperform all the work of the firm that carried out the due diligence to satisfy ourselves for the purposes of the financial statements. In fact, ironically, in this particular case that firm would not release their work to us—that is, their files

and so on—so we had to do all the work again because we needed to do that work to be satisfied on the financials. It was somebody well-intentioned saying, 'Please don't do this due diligence work for us because you'll be auditing your own work.' In fact, we had to do that work anyway to do a good audit. They had taken a prescriptive approach and said, 'Don't do it in this case,' and F1 actually addresses that. The language in F1 is very well drafted to test that principle.

Senator CONROY—Where do you stop with the argument about conducting an audit of your own work? Blake Dawson Waldron have just conducted an audit of their own audit and found themselves completely innocent of any impropriety. While I was sure they were always going to come up with that answer because it was true, where do you try and find an end point if an accusation is made? The argument goes: 'That person did some work, and it wasn't quite right so we had to get an independent person in.' Then it goes: 'I didn't like that independent person, so let's get another independent person in to look at that.' Where does the chain stop?

Mr Harrington—I think this goes to the comment I made earlier that there appears to be an extensive fascination with this concept of independence. That fascination is clearly warranted in a number of circumstances but the judgments that need to be applied need to be applied in a broad and balanced way. To go to the specifics of your question, I do not know where you draw that line because I think the line will continually move depending upon—

Senator CONROY—How long is a piece of string, ultimately.

Mr Harrington—Yes—where perception takes you and where the mood of the community takes you. That is why the distinction needs to be made between issues of independence and issues of conflict. There will always be circumstances where there are issues of conflict and there are mechanisms to deal with that through appropriate probity type reviews. I think that the better focus in respect of the audit role should recognise that very few audit failures, when you go back through history, can tag the fact that the failure occurred because of a lack of independence. I do not think there is any documented evidence of that being the case. Failure occurs due to inappropriate application of auditing procedures, failure of judgment, fraud or some other issues that come into play. The debate—we as an industry are continuing to try and enhance the debate—should focus on quality in the context of the work performed and quality in the context of the capability of individuals. If we create an environment where there is a heightened level of prescription around the profession because the quality of the people within it are not what we would like them to be, we will ultimately achieve what we did not want to achieve—that is, the talent within the profession will not be of a calibre capable of fulfilling the duty that we ultimately wanted them to fulfil in the first place: to undertake a quality audit. So it is a matter of balance.

Senator CONROY—Thank you.

ACTING CHAIR—Thank you, Mr Harrington and Mr Ward. I declare the meeting closed.

Committee adjourned at 4.25 p.m.